Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Review of the Commission's Rules Regarding	)	
the Pricing of Unbundled Network Elements	)	WC Docket No. 03-173
and the Resale of Service by Incumbent Local	)	
Exchange Carriers	)	

INITIAL COMMENTS OF BROADVIEW NETWORKS, INC.; ESCHELON TELECOM, INC.; KMC TELECOM, INC.; MPOWER COMMUNICATIONS CORP.; NUVOX, INC.; SAGE TELECOM, INC.; TALK AMERICA, INC.; XO COMMUNICATIONS, INC.; AND XSPEDIUS COMMUNICATIONS LLC

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Dated: December 16, 2003

SUMMARY

The CLEC TELRIC Coalition, composed of nine CLECs using a wide array of entry strategies which include the use of UNEs to varying extents, submits that the Commission's TELRIC pricing methodology is not broken or in need of repair. Indeed, the very prospect of significant changes to TELRIC fuels regulatory uncertainty to the harm of CLECs and consumers alike. Moreover, as explained in the Declaration of Terry Murray and Scott Cratty sponsored by the CLEC TELRIC Coalition and submitted herewith, practical "real world" experience with the application of the TELRIC framework suggests that there is little to be gained from the proposed changes and much to be lost.

The sole tentative conclusion in the NPRM (pointing toward the use of "real world" routing and topography) and many of the other proposals considered therein all suffer from the same malady: they seek to infuse the Commission's section 252 pricing rules with elements of embedded cost rate making. The Commission considered and rejected its tentative conclusion seven years ago. For those who may have forgotten, the *Local Competition Order* remains a compelling read.

Nearly six years of litigation, culminating in the Supreme Court's *Verizon* decision affirmed that the Commission's decision was the right one. The *Verizon* decision, too, remains a compelling (and controlling) read. Departures from the TELRIC forward-looking economic cost methodology merely perpetuate monopoly inefficiencies to the ILECs' benefit and at the expense of CLECs and consumers alike.

Notably, concern for consumers is absent from the *NPRM*. Before acting, however, the Commission must be sure to consider who will suffer from higher UNE rates and who will gain. Review of the statute, *Verizon* and the *Local Competition Order* all confirm that

Congress intended for consumers to reap the benefits of forward-looking cost-based access to networks they paid for (that currently are controlled by the ILECs).

Yet, there is at least in some quarters the perception that the ILECs and the Bells in particular are poor helpless victims that have been suffering for far too long at the hands of state regulators charged with applying the FCC's pricing rules. That perception is unfounded. The ILECs –especially the Bells – are not helpless nor are they victims. They merely have lost in litigation seeking to render UNEs useless by derailing TELRIC.

The Bells have won in other respects though. This Commission has granted 271 authority in every state and in so doing has determined that TELRIC rates are within a range of reasonableness. Although some rates were pushed downward into the range, we are unaware that any Bell company has ever demonstrated that TELRIC rates are confiscatory and in need of being pushed up into the range of reasonableness.

There is also the perception that TELRIC is "too hypothetical" and that the states didn't all know what to do with the FCC's guidelines. This perception, too, is unfounded. Indeed, TELRIC studies today adequately factor-in involuntary "real world" topographical impediments. And, ILECs typically do not have verifiable data inventorying such "real world" attributes. When the ILECs do have data that may be useful in establishing forward-looking inputs (such as competitive bids and switch vendor contracts), they try not to disclose it. Nevertheless, the Supreme Court and this Commission have commended the states for their efforts in applying the TELRIC guidelines and the states themselves are generally satisfied with the guidelines and job they have done with them.

Yet another unfounded perception is that TELRIC discourages investment. The *Local Competition Order* and *Verizon* say otherwise. Economic theory and empirical data also say otherwise. TELRIC encourages efficient investment – by both ILECs and CLECs alike.

And so, when faced with an *NPRM* that calls into question virtually all that has been well settled (and settled well), the CLEC TELRIC Coalition urges the Commission to act with precision, caution and restraint. If there is a problem, require proof of it. If a fix is needed, tailor a remedy tightly. In short, if the Commission seeks to improve one of its most successful recipes it would be unwise to change any ingredient dramatically or to change many at once.

If there is a place to start, the Commission should do so by providing guidance on the impact of its *Triennial Review Order.* Diminished and diminishing access to UNEs means that the costs, expenses and higher risks associated with protected "next generation" networks must be removed from UNE rates. To aid in this process the Commission should take steps to ensure transparency and verifiability and require the disclosure of all potentially relevant ILEC data. To ensure that smaller CLECs, such as the members of the CLEC TELRIC Coalition, are able to participate in the process, the Commission should also put an end to the common ILEC tactic of using the discovery process in these proceedings as both a shield and a sword.

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Broadview Networks, Inc. ("Broadview Networks"), Eschelon Telecom, Inc. ("Eschelon"), KMC Telecom, Inc. ("KMC"), Mpower Communications Corp. ("Mpower"), NuVox, Inc. ("NuVox"), Sage Telecom, Inc. ("Sage"), Talk America, Inc. ("Talk"), XO Communications, Inc. ("XO"), and Xspedius Communications LLC ("Xspedius") (collectively, the "CLEC TELRIC Coalition"), through counsel, hereby submit into the record these joint comments, including the attached Declaration of Terry L. Murray and D. Scott Cratty in response to the Notice of Proposed Rulemaking ("*NPRM*") in the above-captioned proceeding.[1]

I. INTRODUCTION

The Telecommunications Act of 1996[2] was enacted to fundamentally change telecommunications regulation. One principal objective of the 1996 Act was to open the monopoly-controlled local exchange network to competitive entry in order to bring new and

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1 Review of the Commission's Rules Regarding the Pricing of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers, WC Docket No. 03-173, *Notice of Proposed Rulemaking*, FCC 03-224 (rel. Sept. 15, 2003) ("*NPRM*").

2 Pub. L. No. 104-104, 110 Stat. 56, *codified at* 47 U.S.C. §§ 151 *et seq*. (West 2000) ("1996 Act").

innovative services and lower prices to American consumers.[3] Congress deemed that regulatory intervention was necessary because government sanctioned monopolies had bestowed upon incumbent local exchange carriers ("ILECs") an "almost insurmountable competitive advantage."[4] To expedite the development of fair and efficient competition, the 1996 Act established three modes of entry – the construction of new networks, the use of unbundled network elements ("UNEs") of the ILEC's network, and resale – with no preference for any mode. Where ILECs and competitive local exchange carriers ("CLECs') could not agree on rates for UNE entry, Congress directed the Commission to adopt a pricing methodology that gave "aspiring competitors every possible incentive to enter local retail telephone markets, short of confiscating the incumbent's property."[5] In response to this mandate, the Commission determined that the best approach to advance Congress's intent to promote efficient competition in the local telecommunications market while at the same time complying with the clear directive that the pricing standard must depart from traditional rate-of-return or other rate-based setting practices (such as using historical or embedded costs) was the Total Element Long-Run Incremental Cost ("TELRIC") methodology.[6] This methodology prices network elements on a forward-looking, long-run economic cost basis.

TELRIC-based pricing has enabled CLECs to enter markets where UNEs are necessary to support competition, and bring innovative services and lower prices to consumers as

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3 H.R. Rep. No. 104-204, 104th Cong. 2d Sess at 1 (1996) (1996 Act is intended "to promote competition and reduce regulation in order to secure lower prices and higher quality services for American telecommunications consumers and encourage the rapid deployment of new telecommunications technologies") ("House Report").

4 *Verizon v. FCC*, 535 U.S. 467, 533 (2002) ("*Verizon*").

5 *Id.*, 535 U.S. at 490.

6 Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, *First Report and Order*, 11 FCC Rcd. 15499, 15812-917 (¶¶ 618-836) (1996) ("*Local Competition Order*").

Congress intended. TELRIC has survived 6 years of ILEC legal challenges and has been endorsed by the Supreme Court as being consistent with the 1996 Act. After years of uncertainty, the TELRIC methodology is now something that is much easier for states to grasp and implement than ever before. As the Commission has routinely found it its 271 decisions, states have continually proven that they have the ability to develop UNE rates that both satisfy the unique market conditions of their particular state as well as comply with TELRIC principles and assumptions.

The Commission in this proceeding must do nothing to disrupt this progress. Each of the proposed changes to TELRIC must be reviewed in the context of its impact on consumers. For, as the CLEC TELRIC Coalition demonstrates herein, TELRIC has spurred investment by both ILECs and CLECs, has brought new services and service packages, and has lowered rates – all for the benefit of consumers. Any change to the TELRIC standard that would base prices on embedded costs, historical investment, or rate-base/rate-of-return methodologies would reverse this pro-competitive course and rob consumers of the benefits they only recently have begun to realize.

Moreover, there is no justification for changing TELRIC in any significant way. None of the ILEC-sponsored myths about TELRIC is well-founded, let alone true. TELRIC does not impede investment. TELRIC does not result in below-cost UNE rates. TELRIC is not based on a network that bears no relation to the "real world." Finally, TELRIC has not been a failure in the state commissions, as the *Verizon* decision affirmed.

The sole tentative conclusion,[7] if adopted, will impact consumers in a negative, and perhaps irrevocable, way. The CLEC TELRIC Coalition strongly urges the Commission to reject its tentative plans to overhaul TELRIC, and to stay with current TELRIC standards in order to permit competition to continue to develop in an environment that is pro-competition, pro-consumer, and free from regulatory uncertainty.

Myths About TELRIC Pricing Methodology

The *NPRM* appears to be infused with several false assumptions about what TELRIC means as a matter of policy and practice. Examination of these assumptions reveals that changes to TELRIC are not warranted, and indeed would be harmful to consumers and to competition. The CLEC TELRIC Coalition therefore identifies and discusses what it finds to be several "myths" about TELRIC that, once explained, demonstrate that the Commission's proposed action in this proceeding is unnecessary and ill-advised.

1. Myth # 1: TELRIC Methodology is Too Hypothetical

The argument that TELRIC is too hypothetical or unrealistic has already been rejected by the Supreme Court. The ILECs have persistently complained that basing UNE costs on a forward-looking competitive network is unwise or unfair. Yet Section 252 requires this approach, because it seeks to ensure that new entrants pay only the reasonable costs associated with an open network, and not the price of historical, inefficient costs that the ILECs made as a monopolist. The Supreme Court found this interpretation eminently reasonable, admonishing the ILECs that Congress intended that network cost be divorced from historical investment, and that concept simply requires ILECs to realize that equipment may have a different value in a

[7] *NPRM* ¶ 52.

competitive network. The "hypothetical" hobgoblin has therefore been dispelled, providing no grounds for the Commission to change TELRIC.

2. Myth # 2: TELRIC Does Not Accurately Account for "Real-World" Network Routing and Construction

We have long heard ILEC complaints that TELRIC does not accurately reflect the existing ILEC networks, and now the *NPRM* has embraced this issue. It is a false concern. The newer generation cost models, according to our experts Terry Murray and Scott Cratty, provide very sophisticated information about requirements for network routing and topology. Thus, existing TELRIC models can already provide UNE costs that take into account "real-world" conditions to the extent necessary and reasonable to enable state commissions to very closely approximate forward-looking economic costs in the "real-world." As TELRIC models already capture relevant "real-world" conditions, there is no need to change TELRIC principles in order to force States to examine only embedded ILEC data. Indeed, as experts Murray and Cratty explain, there is no basis for presuming that the ILECs' embedded data more closely reflect forward-looking "real-world" conditions than do the data in existing TELRIC models.

3. Myth # 3: ILECs Should Be Permitted to Recover Embedded Costs

Whether explicitly or implicitly included in the proposed tentative conclusion,[8] embedded costs have no place in Section 252 cost-based pricing. The Supreme Court expressly found that embedded costs are inconsistent with 1996 Act cost principles, and indeed were never fully accepted in utility rate-making as a general matter. Embedded costs reflect historical investment, which, as Ms. Murray and Mr. Cratty (and others) explain, reflects inefficient,

[8] *NPRM* ¶ 52.

monopolistic deployment. To permit ILECs to recover the cost of historical investment would hold the telecommunications market captive to a pre-competitive era and force CLECs – and their customers – to pay for the past missteps and inefficiencies of the ILECs. Accordingly, embedded costs are retrograde and would undo the 1996 Act's goal of spurring competition by promoting efficient, cost-based new entry.

4. Myth # 4: TELRIC Does Not Send the Proper Investment Signals and Provides No Incentive for Carriers to Invest in Facilities

Empirical data, economic theory and the findings of the Supreme Court show that TELRIC has spurred telecommunications investment by ILECs and CLECs alike. Studies have demonstrated that increased CLEC entry results in increased ILEC investment. Data also show the direct connection between UNE rates and investment, whereby a decrease in UNE rates of (x) results in ILEC investment of more than 2(x). These data comport with settled economic theory that market players facing no competition would rather seek to maximize the profit of existing facilities rather than invest in additional facilities. No rational monopolist would innovate unless forced to do so by competitive pressure. The Supreme Court expressly recognized this fact in *Verizon*, dismissing ILEC arguments that TELRIC was impeding investment in the telecommunications sector. Changing TELRIC in order to encourage investment is therefore a misplaced concept.

5. Myth # 5: TELRIC Rates for UNEs Have Resulted in ILEC Under-Recovery

The ILECs have not suffered below-cost UNE rates under TELRIC. The TELRIC rules carefully account for all manner of forward-looking ILEC costs, both operational and capital-related, and require separate findings for each one. ILECs have certainly always had

at least equal voice in the proceedings that develop TELRIC results and ILEC-specific data has always played a central role in TELRIC proceedings. Thus, ILECs have every opportunity to ensure that their legitimate, efficiently incurred costs are recovered. In fact, for this reason it is more likely the case that TELRIC results in over-recovery of costs, because ILEC data are often so imprecise or are based on unreasonable assumptions about their facilities. Moreover, should an ILEC have actual evidence that any specific state commission TELRIC analysis produced unreasonable or confiscatory results, it has always had recourse to both the courts and this Commission.

Instead of being based on relevant factual data, however, the ILEC concerns about under-recovery are based on the foundational (but wrong) belief that ILECs are entitled to recover historical, inefficient costs. The Supreme Court and Congress's plain language demonstrate that ILECs are not so entitled. Congress stated that UNE pricing must be based on a new model of pricing, not the rate-of-return pricing that ruled during the pre-1996 Act period. It is therefore incorrect as a matter of law to argue that UNE prices are too low if they do not allow ILECs to recover historical or embedded costs. Recovering embedded costs has never been the goal of TELRIC, nor should it be.

6. Myth # 6: Since the Commission Addressed Concerns About High UNE Rates in 271 Proceedings – It Now Only Needs to Be Concerned About Low UNE Rates

The Commission conditions Section 271 approval on a finding that the applicant's rates are within an acceptable range of permissible TELRIC outcomes. For these findings, the Commission has relied upon – and repeatedly praised – the work of state commissions that conducted exhaustive analysis of UNE rates and determined them to be TELRIC-compliant.

And in the instances in which ILECs used the "benchmarking" approach, the rates adopted are still TELRIC-compliant. That is, even if the ILEC adopted for one state the rates that were approved by another, those adopted rates have been fully vetted and approved by a state commission for that same ILEC and have been pronounced by the FCC to be in a range or reasonable TELRIC outcomes. Therefore, there is no basis for the ILECs to assert that 271 proceedings resulted in the establishment of UNE rates that do not permit recovery of an ILEC's forward-looking economic costs.

7. Myth # 7: State Proceedings Have Been Difficult to Implement, Are Inconsistent, and Take Too Long Because TELRIC Pricing Methodology is Unclear

State commissions have increasingly become experts in applying TELRIC, particularly as the meaning of the Commission's TELRIC guidelines has become clearer over the years by subsequent deliberation and through the process of legal challenge and subsequent judgments. To the extent that state commission records tend to be large and contentious that is due in significant part to the fact that the ILECs inject mountains of (undocumented and not relevant) embedded data and creatively interpret TELRIC to already require the same as the "real-world" standard they are urging the Commission to move on. Thus the ILECs tend to present the states with a wide range of non-TELRIC data that the state commissions must wade through to develop TELRIC results. Despite that ILEC-driven complexity, the latest round of UNE rates are generally sensible and well-documented. To derail or overhaul TELRIC now would undo years of settled litigation and state commission deliberation, plunging UNE rates and local competition further into an abyss of uncertainty. It is moreover unwarranted, as states have

proven their commitment to applying TELRIC in a manner that is consistent with Commission rules.

II. THE CLEC TELRIC COALITION MEMBERS ARE VIBRANT COMPANIES WHOSE SUCCESS WILL BE THREATENED IF THE COMMISSION TAKES THE ACTION IT PROPOSES

The CLEC TELRIC Coalition consists of a diverse group of companies that are all actively competing with the ILECs through a wide array of entry strategies. Each member provides innovative services and service combinations (which the ILECs had never made available until confronted with real competitive challenge) at superior value to business and residential customers. In short, the CLEC TELRIC Coalition members exemplify the efficient and robust competitors that Congress envisioned when it enacted the 1996 Act.

We encourage the Commission to familiarize itself with the companies making today's local exchange competition a reality by taking a closer look at each member of the CLEC TELRIC Coalition. These are the companies deploying advanced telecommunications capability and redundant networks. Without companies such as these, the nascent wireline local competition that has emerged since 1996 will suffer substantially. A brief description of each coalition member follows. More detailed profiles of each member are attached at **Exhibit 1**.

Broadview Networks – Broadview Networks is a facilities-based and unbundled network element – platform ("UNE-P") reliant integrated telecommunications service provider that currently offers local, long distance and international voice telephone service, plus dial-up, high-speed Internet access and data networking services to small and medium-sized businesses and residential customers throughout the Northeastern and mid-Atlantic United States. In addition to using UNE-P, Broadview Networks has expanded its own network through the

purchase of telecommunications assets previously operated by Network Plus and Net2000 Communications, Inc.

Eschelon – Eschelon is a facilities-based integrated provider that currently offers a comprehensive array of telecommunications and Internet services, including local and long distance telephone service, dial-up and high-speed Internet access, voice messaging, business telephone systems, dedicated T-1 access, network solutions, and Web hosting, to small and mid-sized business customers. Using UNE-P, its own switching equipment, and its own collocated transmission equipment located in 101 collocations, Eschelon currently serves more than 38,000 business customers, in 12 markets and 7 states.

KMC Telecom – KMC is an integrated communications service provider that currently offers voice and broadband data services primarily to businesses, institutional end users, governmental organizations and telecommunications carriers within more than 35 Tier-3 markets in the Southern, Mid-Atlantic and Midwestern United States. Using its own fiber optic networks, KMC provides communications services nationwide to over 2.8 million access and dedicated customer lines. In additional to its integrated communications services, KMC offers consulting, financing, engineering and operations support for national, regional and local access infrastructures, Internet Service Providers, interexchange carriers, utility and power companies and wireless carriers.

Mpower Communications – Mpower is a facilities-based integrated communications service provider that currently offers bundled local and long distance telephone services, broadband data services, Internet access, and Web hosting solutions using its own dedicated symmetrical digital subscriber line technology, voice over SDSL, Trunk Level 1,

Integrated T1, and Data-only T1. Mpower currently provides service to approximately 53,000 small and mid-sized business customers, as well as to residential customers, in select geographic markets, including Los Angeles, San Diego, Las Vegas, northern California and Chicago.

NuVox – NuVox is a facilities-based integrated communications service provider that currently offers bundled voice, data and Internet products and services to businesses and other end users within 30 markets located in the Midwest and Southeastern United States. NuVox currently provides its integrated voice and data services, using its own network, including voice, data and ATM switching technology and collocations, combined with leased loop and transport facilities obtained from ILECs and other providers, to more than 17,000 customers, with more than 265,000 customer access lines in service.

Sage Telecom – Sage is a competitive provider of local and long distance telephone services and features. Sage's target markets include residential and small business customers located primarily within rural and suburban communities outside major metropolitan areas. Sage provides its bundle of communications services and features using a combination of unbundled network elements, wholesale long distance products, voice mail equipment, operations support systems and electronic data interfaces obtained from the incumbent LEC, and currently operates over 500,000 customer access lines within SBC's service territory.

Talk America – Talk is an integrated communications service provider that currently offers bundled long distance using its own facilities and local voice services using UNE-P and total service resale to residential and small business customers throughout the United States. At present, Talk operates approximately 495,000 customer access lines in 29 states.

XO Communications – XO is a facilities-based integrated communications service provider that offers a broad array of telecommunications services in markets throughout the nation, including local and long distance voice services, Internet access, Virtual Private Networking, Ethernet, wavelength, Web Hosting and integrated services to small and mid-sized business customers, enterprise customers, and other telecommunications carriers. XO Communications currently offers integrated business solutions on a nationwide basis, using its expansive OC-192 Internet backbone and other network assets.

Xspedius – Xspedius is an integrated communications service provider that currently offers long distance, local access, dedicated Internet access and other data services to business and wholesale customers throughout the United States. Through its subsidiary, Xspedius Fiber Group, the company also provides fiber-optic network infrastructure solutions, including dark fiber and conduit, and network design and construction services to organizations deploying network systems in major metropolitan markets within the United States, including local and long distance carriers, Internet Service Providers, municipalities, utilities and Fortune 500 companies. The Xspedius entities currently operate in 52 markets, located in 24 states and the District of Columbia, with over 3,500 route miles of deployed fiber.

III. THE TELRIC PRICING METHODOLOGY IS NOT BROKEN

The CLEC TELRIC Coalition, who collectively are implementing a wide array of entry strategies incorporating their own facilities as well as UNEs, are in full agreement that the current TELRIC guidelines are not broken and do not need to be fixed. Indeed, changing the basis for pricing UNEs at this stage, after the Supreme Court has affirmed the reasonableness of the TELRIC standard and finally provided much needed regulatory certainty, will unnecessarily

destabilize and irreparably harm competition. Such changes would inevitably be met with variations in interpreting the changes and accompanied by litigation in the courts and in each state.

The CLEC TELRIC Coalition supports the Commission's decision to refuse to reconsider its basic approach that forward-looking economic costs are the only basis for setting UNE prices that promote economic efficiency. It is well settled that when prices properly reflect forward-looking economic costs, consumers buy the "right" quantities of goods and services because prices signal the cost of the resources used to produce these goods and services.[9] Changing the basis for pricing UNEs at this stage, after the Supreme Court has affirmed the reasonableness of the TELRIC standard and finally provided much needed regulatory certainty, would unnecessarily destabilize and irreparably harm competition.

A. The Supreme Court Found that the TELRIC Pricing Methodology Represented a Reasonable Approach to Establishing UNE Rates

After years of litigation and uncertainty, TELRIC has been definitively affirmed as legally consistent with the letter and intent of the 1996 Act. Thus, the range of dispute over what the Commission's current TELRIC standard requires and how it should be implemented has finally begun to narrow. TELRIC is now something that is much easier to grasp and implement than ever before.

The Supreme Court unequivocally affirmed in *Verizon*[10] that the Commission's current forward-looking TELRIC pricing rules represent a reasonable method for pricing unbundled network elements and that such rules were adopted after the Commission had

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9 *Murray-Cratty Declaration* ¶ 23. Attached hereto as **Exhibit 3**.

10 *Verizon*, 535 U.S. 467.

thoughtfully and deliberately considered and rejected several alternatives. *Verizon* thus vindicated the Commission's current methodology that prices network elements on a forward-looking long-run economic cost basis. It is therefore puzzling that the Commission now proposes (or at least is considering) to make a host of significant changes to the TELRIC pricing rules, particularly since many of the assumptions underlying the proposed changes track almost identically the arguments made by the ILECs in *Verizon* that the Supreme Court rejected as being inconsistent with the statutory language of the 1996 Act, congressional intent, and the underlying record. But for the Commission's decision in the *Triennial Review Order* to limit competitive access to certain network elements, there has been no change in circumstances since 1996 that would justify making fundamental modifications to the TELRIC pricing rules.[11]

Verizon dispelled several myths about the current TELRIC pricing rules that have been propounded by the ILECs since the *Local Competition Order* was adopted in 1996. These findings controvert certain critical assumptions infused in the *NPRM* that appear to provide the basis for many of the proposed rule changes. However, for reasons unexplained, the *NPRM* appears to ignore the critical findings of *Verizon* that are directly relevant to this proceeding. It is imperative that the Commission give due consideration and deference to the Court's holdings before making any modifications to the TELRIC pricing methodology.

[11] As discussed in Section VIII of these Comments, because the *Triennial Review Order* limits competitive access to certain network elements, the Commission should ensure that UNE rates exclude the costs associated with parts of the ILEC network that CLECs no longer have authority to access or use, and do not reflect the higher risks of the "next generation" network elements no longer available on an unbundled basis.

1. The Court found that ILECs have an "insurmountable" advantage over competitors

In *Verizon*, the Court found that Congress never intended the 1996 Act to treat the ILECs and competitors as equals because of the ILECs' ability to control bottleneck local facilities to impede free market competition. As the Court explained, the "Act proceeds on the understanding that incumbent monopolists and contending competitors are unequal."[12] Moreover, Congress deemed intervention necessary because, due to the high cost of entry, ILECs have an "almost insurmountable competitive advantage."[13] As the Court explained:

> For the first time, Congress passed a rate setting statute not just to balance interests between buyers and sellers, but to reorganize [telecommunications] markets by rendering regulated utilities' monopolies vulnerable to interlopers, even if that meant swallowing the traditional federal reluctance to intrude into the local telephone markets. This approach was deliberate, through a hybrid jurisdictional scheme with the FCC setting a basic, default methodology for use in setting rates when carriers fail to agree, but leaving it to state utility commissions to set the actual rates.[14]

Given the need for ILECs to cooperate with entrants in providing essential inputs and the obvious incentives for ILECs to refuse such cooperation due to their superior market power, the Court found that "the FCC was reasonable to prefer TELRIC over alternative fixed-cost schemes that preserve home-field advantages for the incumbents."[15]

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12 *Verizon*, 535 U.S. at 533.

13 *Id.*, 535 U.S. at 490.

14 *Id.*, 535 U.S. at 489.

15 *Id.*, 535 U.S. at 490.

2. The Court recognized that ILECs have no incentive to deal with CLECs

The Court explained that Congress recognized that, because of their superior market power, ILECs lacked any incentive to cooperate with new entrants. Specifically, the Court found that the local competition provisions of the 1996 Act called for the Commission to adopt "a rate making [methodology] different from any historical practice, to achieve the entirely new objective of uprooting the monopolies that traditional rate-based methods had perpetuated."[16] Moreover, the Court found that Section 252(d)(1)'s plain statutory language reflected Congress's directive to depart from the traditional regulatory approach that had prevailed prior to the Act. Specifically, the Court found that while Section 252(d)(1) is like its predecessors in tying the methodology to just and reasonable and nondiscriminatory rates, it was deliberately drafted to be significantly different in that it explicitly disavows "the familiar public-utility model of rate regulation . . . in favor of a novel rate setting designed to give aspiring competitors every possible incentive to enter local retail telephone markets, short of confiscating the incumbent's property."[17] Yet, despite these specific findings, and particularly Congress's clear directive to depart from past rate setting practices, the *NPRM* proposes to change the TELRIC pricing rules to effectuate something much closer to historical pricing methodologies.

3. The Court found no preference for full facilities-based competition in the 1996 Act

The Court also rejected ILEC claims that the 1996 Act preferred full facilities-based competition over UNE-based entry or resale. The Court found it reasonable for the Commission to induce potential entrants to compete by sharing facilities that are expensive to

[16] *Verizon*, 535 U.S. at 488.

[17] *Id.*, 535 U.S. at 489.

duplicate rather than require them to build their own bottleneck facilities when the alternative was "to risk keeping more potential entrants out."[18] In upholding the Commission's decision to permit entry into the local exchange market on a non-facilities basis, the Court explained:

> a policy promoting lower lease prices for expensive facilities unlikely to be duplicated reduces barriers to entry (particularly for smaller competitors) and puts competitors that can afford these wholesale prices (but not the prices the incumbents would like to charge) in a position to build their own version of less expensive facilities that are sensibly duplicable.[19]

Despite the Court's clear finding that Congress did not prefer pure facilities-based competition over other methods of entry, including UNE-based entry, the *NPRM* finds to the contrary that the 1996 Act favors facilities-based competition over UNE entry.[20] It is not the Commission's prerogative to second-guess Congress or the Court.

4. The Court found that TELRIC cost-based unbundling has not impeded investment

The Court rejected the ILECs' argument that TELRIC impedes investment as being contrary to fact. The ILECs argued that while TELRIC may simulate the competition envisioned by the Act, TELRIC will not stimulate investment because TELRIC assumes a perfectly efficient market wherein no one who can lease at a TELRIC rate will ever build. The Court gave three reasons for rejecting the ILECs' claim. First, the Court found that TELRIC's existing wire center configuration requirement tolerates some degree of inefficient pricing, which undermines the ILECs' claim that TELRIC assumes a perfectly competitive efficient wholesale

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18 *Id*., 535 U.S. at 510.

19 *Id*., 535 U.S. at 503 n.20.

20 *NPRM* ¶ 3.

market.[21] Next, the Court rejected the ILECs' claim that TELRIC prices will be adjusted downward with each technological innovation instantaneously, explaining that TELRIC rates in practice will differ from the products of a perfectly competitive market because of built-in lags in price adjustments that necessarily follow because competitors do not always know when the ILECs' costs decline. When CLECs become aware of ILEC cost declines, state utility commission rate setting processes will result in changes over years, and not days.[22] Third, the Court found that the Commission's own statistics and the record showed "substantial resort to pure and partial facilities based competition among the three entry strategies . . . [and] substantial competitive capital spending over a 4-year period."[23] The Court concluded that "so long as TELRIC brings about some competition, the incumbents will continue to have incentives to invest and to improve their services."[24]

Thus, it is clear from this discussion that the Court discerned that Congress believed that wireline competition is the most effective way to stimulate wireline investment. The Supreme Court recognized this fact by sharply rejecting the ILECs' argument that TELRIC has a negative impact on investment incentives. After reviewing data, such as the fact that CLECs had invested $55 billion dollars by 2000, the Court held that TELRIC "is not an unreasonable way to promote competitive investment in facilities."[25]

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21 *Verizon*, 535 U.S. at 509.

22 *Verizon*, 535 U.S. at 509. (The Court reasoned that UNE rates from state arbitration proceedings should be expected to remain in effect for 3-4 years).

23 *Id.*, 535 U.S. at 517.

24 *Id.*, 535 U.S. at 517 n.33.

25 *Id.*, 535 U.S. at 517.

5. The Court found that excluding embedded costs is reasonable under Section 252, as using embedded costs may inflate service rates

Finally, while the Court found that the statutory language places at least a "heavy presumption" against any method using embedded costs, it also indicated that "there is even an argument that the Act itself forbids embedded-cost methods."[26] The Court explained that:

> If leased elements were priced according to embedded costs, the incumbents could pass these inefficiencies to competitors in need of their wholesale elements, and to that extent defeat the competitive purpose of forcing efficient choices on all carriers whether incumbents or entrants. The upshot would be higher retail prices consumers would have to pay.[27]

It therefore is not at all clear that permitting the inclusion of embedded (*i.e.*, historical) costs in a modified TELRIC standard would be lawful. Given the Court's strong language, the Commission should avoid adopting any modifications to the TELRIC pricing standard that would permit ILECs to recover embedded costs.

B. The Commission's 271 Decisions Do Not Support the Presumption that Certain UNE Rates are Too Low

As noted in the *NPRM*,[28] the Commission, as part of its statutory mandated review of ILEC applications for authority to provide in-region interLATA services, considers whether the ILEC offers access to UNEs at rates that conform with the TELRIC pricing methodology.[29] In reviewing state pricing decisions, the Commission determines whether the

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[26] *Id.*, 535 U.S. at 512.

[27] *Verizon*, 535 U.S. at 512.

[28] *NPRM* ¶ 26.

[29] 47 U.S.C. § 271(d). The FCC recently completed work on the 49th and final application of an ILEC to offer in-region long distance service. *See* Application by Qwest Communications International Inc. for Authorization to Provide In-Region, InterLATA Services in Arizona, WC Docket No. 03-194, *Memorandum Opinion and Order*, FCC 03-309 (rel. Dec. 3, 2003).

state has established rates that are within the range that a reasonable application of TELRIC principles would produce.[30]

Any inference that state commissions have failed to correctly apply the Commission's TELRIC standard completely contradicts myriad factual findings of this Commission. In fact, the Commission repeatedly has commended state commissions for their commitment to TELRIC principles. For example, in the *New York 271 Order*, the Commission stated "[w]e stress that we place great weight on the New York Commission's active review and modification of Bell Atlantic's proposed unbundled network element prices, its commitment to TELRIC-based rates, and its detailed supporting comments concerning its extensive, multi-phased network elements rate case, as discussed below."[31] Likewise, in the *Michigan 271 Order*, the Commission found that, "[i]n determining the appropriate UNE rates, the Michigan Commission followed basic TELRIC principles. . . .[T]he orders of the Michigan Commission provide numerous indicia that it followed a forward-looking approach that is consistent with TELRIC. We find that the Michigan Commission has worked diligently to set UNE rates at TELRIC levels." [32] Similarly, in the *Georgia/Louisiana 271 Order*, the Commission observed that "the Georgia Commission recognized the importance of making modifications to BellSouth's cost model to ensure that the rates it established were forward looking, and in fact

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30 *NPRM* ¶ 27.

31 Application by Bell Atlantic New York for Authorization Under Section 271 of the Communications Act To Provide In-Region InterLATA Service in the State of New York, *Memorandum Opinion and Order*, 15 FCC Rcd. 3953, 4081-82 (¶ 238) (1999) ("*New York 271 Order*").

32 Application by SBC Communications Inc., Michigan Bell Telephone Company, and Southwestern Bell Communications Services, Inc. for Authorization To Provide In-Region, InterLATA Services in Michigan, *Memorandum Opinion and Order*, 18 FCC Rcd. 19024, 19048 (¶ 50) (2003) ("*Michigan 271 Order*").

did so in several other instances."[33] In the *Kansas/Oklahoma 271 Order*, the Commission found that "[t]he Kansas Commission's orders show a consistent application of TELRIC principles in the setting of recurring prices."[34] Similar statements applauding the states' commitment to TELRIC principles exist for other states.

In fact, although the Commission has found that various aspects of state pricing decisions appeared to be inconsistent with the forward-looking cost principles on which the TELRIC pricing rules are based,[35] the Commission has never once criticized the state commissions for setting TELRIC rates too low. In fact, the exact opposite is true. The only negative statements that the Commission has ever made regarding state TELRIC determinations have been related to rates that appeared to be set too high and thus were outside the range of reasonable TELRIC outcomes established by the Commission.[36]

The Commission's 271 decisions thus belie some of the supposed rationales currently made for opening this proceeding. As evidenced by the abundance of endorsing

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[33] Joint Application by BellSouth Corporation, BellSouth Telecommunications, Inc., and BellSouth Long Distance, Inc. for Provision of In-Region, InterLATA Services in Georgia and Louisiana, *Memorandum Opinion and Order*, 17 FCC Rcd. 9018, 9047-48 (¶ 53) (2002) ("*Georgia/Louisiana 271 Order*").

[34] Joint Application by SBC Communications Inc., Southwestern Bell Telephone Company, and Southwestern Bell Communications Services, Inc. d/b/a Southwestern Bell Long Distance for Provision of In-Region, InterLATA Services in Kansas and Oklahoma, *Memorandum Opinion and Order*, 16 FCC Rcd. 6237, 6264 (¶ 55) (2001) ("*Kansas/Oklahoma 271 Order*").

[35] *NPRM* ¶ 27.

[36] *Id.* ¶ 28. This does not mean, however, that the 271 process has resulted in UNE prices that are biased downward. The 271 process did not wring out all overstated UNE prices. Moreover, the ILECs have engaged in other challenges to UNE prices that resulted in *increases* to prior state-adopted rates. Hence, the presumption that current UNE prices are a ceiling on "correct" UNE prices is simply false. In addition, the CLEC TELRIC Coalition notes that the Commission's range of reasonableness test arguably should have identified rates that were too low and outside the range of reasonable TELRIC outcomes. In any event, the Commission has, outside the 271 context, a process available to consider ILEC claims that TELRIC rates are confiscatory (*i.e.*, too low and outside the range of reasonable TELRIC outcomes). The CLEC TELRIC Coalition also notes that opportunities for review and appeal should be sufficient to protect ILECs from unreasonably low TELRIC rates, especially given the ILECs' penchant for litigating virtually every aspect of the implementation of the 1996 Act's local competition mandates and their vast legal and regulatory resources.

statements, states have continually proven that they have the ability to evaluate costing data, establish inputs, and develop UNE rates that both satisfy the unique market conditions of their particular state as well as comply with TELRIC principles and assumptions.

1. The Commission Must be Careful Not to Undo the Foundation for 271 Approvals – Many of Which Were Granted on the Basis of UNE Competition

The deal struck by Congress in the 1996 Act was to make the ILECs' entry into the long distance market the *quid pro quo* for allowing CLECs to offer local exchange service. The 271 orders were predicated on the availability of UNEs at TELRIC rates sufficient to allow CLECs to compete.

For example, the Commission has found that UNE-P is "integral to achieving Congress' objective of promoting competition in the local telecommunications markets . . . as well as an obligation under the requirements of Section 271."[37] The Commission has rejected 271 applications where the ILEC has imposed limitations on access to combinations of unbundled network elements that significantly impede the development of local exchange competition.[38] In contrast, where the ILEC has been able to point to evidence that CLECs actually use UNE-P to service mass market customers, the Commission has found that Checklist item 2[39] is satisfied.[40]

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[37] *See New York 271 Order*, 15 FCC Rcd at 4077-78 (¶ 230).

[38] *See, e.g.*, Application of Ameritech Michigan Pursuant to Section 271 of the Communications Act of 1934, as amended, To Provide In-Region, InterLATA Services In Michigan, *Memorandum Opinion and Order*, 12 FCC Rcd. 20543, 20719 (¶ 333) (1997); Application of BellSouth Corporation, et al. Pursuant to Section 271 of the Communications Act of 1934, as amended, To Provide In-region, InterLATA Services In South Carolina, *Memorandum Opinion and Order*, 13 FCC Rcd. 539, 647-48 (¶ 197) (1997).

[39] Checklist item 2 of Section 271 states that an ILEC must provide "nondiscriminatory access to network elements in accordance with sections 251(c)(3) and 252(d)(1)" of the Act. 47 U.S.C. §§ 251(c)(3), 252(d)(1).

Because of the significant investment and scale economies required to enter the local exchange market, CLECs would not be able to make a market-wide offering of services without physical access to the ILEC network. UNE-P supports full competition by providing CLECs access to the local exchange network in order to offer all services. Although the ILECs delayed offering UNE-P for several years, once introduced it demonstrated a powerful ability to bring competitive benefits broadly to the mass market.

The most recent Commission local competition industry report shows just how important UNE-P has been for demonstrating that local markets served by the ILECs are open to competition.[41] The availability of reasonably priced UNE-P has been the single greatest contributing factor to effective local competition for mass market consumers. As of December 31, 2002, UNE-P served over 10.2 million residential and small business lines.[42] Presently, UNE-P is the biggest driver of competitive growth in the local market, accounting for more than 85% of the net growth in competitive access lines in 2002.

The Commission must proceed with extreme caution in considering any changes to the TELRIC pricing standard. There is a real and substantial danger that modifying the

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[40] *See, e.g.,* Application of Verizon New England Inc., Bell Atlantic Communications, Inc. (d/b/a Verizon Long Distance), NYNEX Long Distance Company (d/b/a Verizon Enterprise Solutions) And Verizon Global Networks Inc., For Authorization to Provide In-Region, InterLATA Services in Massachusetts, *Memorandum Opinion and Order*, 16 FCC Rcd. 8988, 9052-54 (¶¶ 117-118) (2001); *New York 271 Order*, 15 FCC Rcd at 4079 (¶ 233); Application of Verizon Pennsylvania Inc., Verizon Long Distance, Verizon Global Networks Inc., and Verizon Select Services Inc. for Authorization to Provide In-Regions, InterLATA Services in Pennsylvania, *Memorandum Opinion and Order*, 16 FCC Rcd. 17419, 17460-61 (¶¶ 73-74) (2001).

[41] Federal Communications Commission Industry Analysis and Competition Division, Wireline Competition Bureau, *Local Telephone Competition: Status as of December 31, 2002* (rel. June 2003) ("*FCC Local Telephone Competition Report*"), *available at:* http://www.fcc.gov/Bureaus/Common_Carrier/Reports/FCC-State_Link/IAD/lcom0603.pdf.

[42] *FCC Local Telephone Competition Report* at Table 4.

TELRIC methodology will cause a reduction of competition in the local exchange market and undo the very foundation upon which 271 applications were approved.

C. Parties Have Already Expended Enormous Resources in State Proceedings Which Have Produced Generally Reasonable Results

State public utility commissions have expended significant time and effort adopting TELRIC pricing principles to replicate to the extent possible the conditions of a competitive market.[43] This effort is helping to transform local telephone markets from monopoly to competition. While CLECs continue to gain market share, they can continue apace only if there is no erosion of the Commission's pricing rules that have helped them get this far.

1. Due to seemingly endless litigation and legal uncertainly, it has already taken years to get applications of the methodology right

The TELRIC pricing standard has been under constant attack since it was adopted by the Commission in 1996. In fact, the TELRIC pricing rules were almost immediately challenged upon adoption by the ILECs and a number of state regulators. In 1996 and 1997, the Eighth Circuit stayed and invalidated the Commission's pricing rules on the ground that the 1996 Act gives state public utility commissions, not the Commission, general jurisdiction to interpret the pricing provisions of Sections 251 and 252.[44] The Eighth Circuit's jurisdictional order remained in effect until early 1999. In January 1999, the Supreme Court upheld the Commission's authority to establish pricing rules but did not then rule on the merits of the rules themselves. In July 2000, the Eighth Circuit vacated the rules on the merits. The Commission, AT&T and WorldCom appealed that decision. The Supreme Court upheld the Commission's rules on May 13, 2002.

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[43] *See Murray-Cratty Declaration* ¶ 33.

[44] *Iowa Utils. Bd. v. FCC*, 120 F.3d 753, 794-800 (8th Cir. 1997).

Thus, the rules had been firmly in place for less than a year when the Commission adopted its *Triennial Review Order* modifications and less than two years before the Commission adopted the *NPRM*. After years of litigation and uncertainty, the range of dispute over the meaning of the existing TELRIC standard and how to implement it finally narrowed after the Supreme Court's ruling in 2002.

2. Where states have continued to grapple with TELRIC, rates have become more reasonable and competition has increased

Over the last few years, many states have lowered UNE rates after conducting comprehensive studies based on TELRIC.[45] This has triggered a fierce war between the ILECs and CLECs for customers and created choice, lower prices, and innovative service options and packages for consumers.

Recent Commission reports on local competition show CLEC entry into the local market continues to grow. The Commission reported that CLEC market share has grown from 4.3 percent of switched access lines in December 1999 to 13.2 percent in December 2002. Total CLEC share varies state by state. While their market share is small in all states, CLECs (as a group) service 25 percent of all telephone lines in New York and 21 percent in Michigan, where loop rates are relatively low.[46] In contrast, in states where loop rates are high, CLEC penetration

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[45] For example, between July 2002 and January 2003, twenty-five states adjusted UNE prices. Between January 2003 and July 2002, ten states changed UNE prices. *See* National Regulatory Research Institute, *A Survey of Unbundled Network Element Prices in the United States* at 1 (updated July 1, 2003) ("*Survey of UNE Prices*") *available at:* http://www.nrri.ohio-state.edu/documents/intro0703_000.pdf.

[46] *See FCC Local Telephone Competition Report*, Table 6. The average unbundled loop price is $11.49 in New York and $10.15 in Michigan. *See Survey of UNE Prices*, Table 1.

is much lower. For example, CLECs serve only 6 percent of all telephone lines in Mississippi and 7 percent in South Carolina.[47]

3. States think that they have gotten it right

Contrary to suggestions in the *NPRM*,[48] state public utility commissions generally have not experienced undue difficulty in applying the TELRIC pricing rules in cost proceedings. For example, state commissioners attending a forum sponsored by the Wisconsin Public Utilities Institute in early November 2003, reported that "the TELRIC pricing formula used to set wholesale rates generally has worked well."[49] Forum attendee Elliot Smith, of the Iowa Utilities Board, said that "state commissions generally feel they do a good job of implementing the [TELRIC] formula."[50] Similarly, forum attendee Robert Nelson, of the Michigan Public Service Commission, said "the [TELRIC] formula needs to be tweaked, not overhauled."[51] Moreover, on November 18, 2003, the National Association of Regulatory Utility Commissioners ("NARUC") at its national convention adopted a resolution concerning this proceeding that, among other things, notes that "state commissions have acquired extensive experience setting UNE rates based on the forward-looking cost principles embodied in TELRIC" and that TELRIC pricing "has been a factor in encouraging and sustaining local competition thereby benefiting consumers." Finally, the Supreme Court found that the state public utility commission

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47 See FCC Local Telephone Competition Report, Table 6. The average unbundled loop price is $23.12 Mississippi and $17.60 in South Carolina. *See Survey of UNE Prices*, Table 1.

48 *See NPRM* ¶ 6.

49 Bischoff, Glenn, *State Commissioners Defend TELRIC*, TELEPHONYONLINE.COM, Nov. 7, 2003, *available at:* http://telephonyonline.com/ar/telecom_state_commissioners_defend/index.htm

50 *Id.*

51 *Id.*

proceedings on TELRIC rates "are surprisingly smooth-running affairs."[52] The Court's findings and the remarks from the state commissioners wholly refute suggestions in the *NPRM* that state cost proceedings have been plagued with uncertainty about how to apply the rules.[53]

D. Empirical Evidence as Well as Sound Economic Analysis Demonstrates that TELRIC Stimulates Investment

Further evidence that TELRIC is not broken and in need of a major overhaul is provided by the fact that TELRIC-based access and UNE-based competition has stimulated investment by new entrants and incumbents alike.

1. The premise that current TELRIC rates discourages investment is wrong

The Commission should not allow itself to become captive to the ILECs' propaganda that TELRIC discourages investment. As noted above, the Supreme Court found that argument to be utterly false, finding that CLECs had to that point already invested $55 billion.[54] The latest data shows aggregate investment is now $71 billion, and climbing.[55] This investment, in turn, has spurred ILEC investment[56] – precisely the response that competition should create.

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52 *Verizon*, 535 U.S. at 522.

53 *NPRM* ¶ 6.

54 *Verizon*, 535 U.S. at 517.

55 Progress and Freedom Foundation, Digital Economy Fact Book at 42 (5th Ed. 2003).

56 Kevin A. Hassett, Zoya Ivanova and Laurence J. Kotlikoff, *Increased Investments, Lower Prices – the Fruits of Past and Future Telecom Competition* at 5-8, 48 (Table 1) (Sept. 2003) ("*Increased Investment*") *available at:* http://econ.bu.edu/kotlikoff/HIK%209-16-03.pdf; *see also* PHOENIX CENTER POLICY BULLETIN NO. 4: *The Truth About Telecommunications Investment* (Jun. 24, 2003) (*available at*: http:www.phoenix-center.org/PolicyBulletin/PolicyBulletin4Final.pdf); PHOENIX CENTER POLICY BULLETIN NO. 5: *Competition and Bell Company Investment in Telecommunications Plant: The Effects of UNE-P* (updated Sept. 17, 2003) (*available at*: http://www.phoenix-center.org/PolicyBulleting/PolicyBulleting5.pdf).

a. Competitive access spurs investment

ILEC investment has occurred in direct relation to the amount of competition – principally UNE-based competition – the ILECs face. According to a recent study, ILEC spending has consistently tracked CLEC spending.[57] Studies also demonstrate that BOC spending increased by 22 percent in the period from 1997 to 2000 – after passage of the 1996 Act.[58] When the CLEC industry was investing heavily in the late 1990s, the ILECs responded in kind with heavy investments of their own.[59] When the CLEC industry saw a decline, which began in the first quarter of 2001, ILEC investment began to decline as well.[60] Where CLECs have succeeded, however, such as via UNE-P arrangements, integrated T1s, and other bundled service arrangements, the ILECs have responded with increased investment. For example, one study found that the ILECs on average increase their spending by $759 for each UNE-P line.[61] Likewise, ILECs have had to invest to catch-up with switch and fiber-based CLECs' integrated T1 product offerings.

These figures are not an inexplicable fluke, but rather comport with settled economic theory about monopolistic behavior. As Hassett, Ivanova and Kotlikoff demonstrate in their recent paper, introducing competition into the local exchange market through regulation

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57 Robert D. Willig, Investment is Appropriately Stimulated by TELRIC (filed Dec. 5, 2003, in WC Docket No. 03-173) (hereinafter "Willig").

58 *See* Office of Plans and Policy, Federal Communications Commission, *Telecommunications @ the Millennium: The Telecom Act Turns Four*, Figure 10 (Feb. 8, 2000) (BOCs invested $82 billion from 1992 to 1995 and $100 from 1997 to 2000). (*available at*: http://www.fcc.gov/Speeches/Kennard/2000/telecomatthemilleniumbw.pdf).

59 Willig at 3.7-3.8, 3.16 (chart depicting investment since 1996).

60 *Id.* at 3.16.

61 *Id.* at 3.11.

reduces consumer prices for voice services and spurs investment.[62] Similarly, another recent study provides empirical evidence that UNE-P competition increases ILEC investment in the local telecommunications plant.[63] The persistent nonsense promulgated by the ILECs that TELRIC discourages investment is thus plainly wrong as a matter of theory and empirical evidence.

b. The decline in ILEC investment was a political choice, not an economic necessity

To the extent that the ILECs have decreased their investment, that result was not compelled by TELRIC – it was *allowed* by the diminution of competition. Rampant uncertainty and doubt spawned by the ILECs' refusal to comply with this Commission's rules implementing the 1996 Act and Bell-backed legislative initiatives, such as "Tauzin-Dingell," worked to freeze CLECs out of the capital markets. One by one, CLECs were forced to restructure and many were driven from the market. Faced with diminishing competitive pressures, the ILECs decreased their investment. As shown in the studies cited above, the relation was proportional. No rational monopolist would spend more money to keep its customers when it faced no competitive threat.[64]

Now, however, the ILECs are using their continued threat of halting investment as a political gambit to destroy TELRIC. This Commission should not be deceived by ILEC propaganda and empty promises. The ILECs argued in 1996 that TELRIC would force them not

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62 *Increased Investment* at 16-18.

63 PHOENIX CENTER POLICY BULLETIN NO. 6: *UNE-P Drives Bell Investment: A Synthesis Model* (Sept. 17, 2003) (*available at*: http://www.phoenix-center.org/PolicyBulletin/PolicyBulletin6Final.doc).

64 *See, e.g., Increased Investment* at 11-15.

to invest;[65] the data cited in these comments show the exact opposite result. Indeed, ILEC investment has been most robust when unbundling rules were most robust. Competition forced ILECs to invest, and it will continue to do so if the Commission retains a reasonable semblance of the current cost-based network access rules. If competition dies, however, ILEC investment will most assuredly diminish, and with it innovation and price reductions that would have been driven by the cycle of competition and investment.

c. Regulatory uncertainty, ineffective enforcement and excessive litigation are the true hindrances to investment

It is not TELRIC, but rather the constant waves of uncertainty caused by litigation over, ineffective enforcement and perpetual reconsideration of the Commission's unbundling regime and local competition rules that discourages investment. These are the root causes for any lack of "clear signals" for investment that the Commission perceives.[66] As many CLECs have already experienced, investors are increasingly skittish about funding companies whose rights to utilize a congressionally mandated method of entry is unsettled and constantly permitted to be under siege by monopolists seeking protection from wireline competition.[67] If the Commission seeks to promote investment, it should eliminate the regulatory uncertainty it has created by permitting an environment where ILECs can continue to chip away successfully at reducing the statutory requirements of the 1996 Act.

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65 *Local Competition Order* ¶ 638 ("incumbent LECs argue that setting prices based on the forward-looking economic cost of the element will not create incentives for new entrants to build their own facilities, and will discourage efficient entry and useful investment by both incumbent LECs and their competitors.").

66 *NPRM* ¶ 38.

67 Sections 251 and 252 of the Act simply do not allow the FCC to save the Bells from wireline competition. Nothing in the Act permits wireline competition to be traded away for intramodal competition. This Commission should not stand in the way of consumers reaping the benefits of the Bell monopolies being whittled away by competition from all sides.

In addition, the resources that are drained via litigation translate to less ability to invest. The ILEC tactic of litigating virtually every 1996 Act issue to the death (whether it be the rules themselves or their need to comply with them) has been an important tenet of their overall strategy to retain monopolist control over the local network.

d. The Commission should not alter TELRIC simply to encourage investment for investment's sake

While investment in facilities is in the main a positive thing for telecommunications consumers, the Commission should be mindful of the fact that not all investment is sensible or sensible to encourage. That is, investment that is badly planned or imprudently made brings no benefit to American consumers.

As the CLEC TELRIC Coalition has shown, CLECs must target their investment to markets in which they have a reasonable probability of recouping their investment.[68] Failure to plan in this way greatly decreases a CLEC's chance of survival in the long term. CLEC failures endanger customer service and may strand valuable facilities that go unused.

Congress did not intend for the 1996 Act to result in wasted investment. Rather, Congress sought to "promote innovation and investment"[69] and "set the stage for a new competitive paradigm."[70] Hence, Congress expressly recognized that "it is unlikely that competitors will have a fully redundant network in place when they initially offer local service,

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[68] McCausland Affidavit (Sage) ¶ 5 ("As a CLEC, we do not have the expansive deployment resources that ILECs enjoy. Accordingly, Sage is extremely conservative fiscally, and deploys facilities only where it can reasonably expect a return that will cover their investment."). Attached hereto in **Exhibit 2**.

[69] Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, *Third Report and Order and Fourth Further Notice of Proposed Rulemaking*, 15 FCC Rcd. 3698, 3699 (¶ 2) ("*UNE Remand Order*") *citing* H.R. Conf. Rep. No. 104-458, 104th Cong., 2d Sess. at 113 ("Conference Report").

[70] *UNE Remand Order*, 15 FCC Rcd. at 3699 (¶ 2).

because the investment necessary is so significant."[71] The point of Sections 251 and 252, then, is to enable competitors to gain a presence in the market, via resale or UNEs, and then accrue the necessary capital to invest is equipment that will stabilize their position and improve quality of service. Congress did not champion the notion of investing in facilities haphazardly and then abandoning them. It did not seek investment for investment's sake. Nor should the Commission. The wishful philosophy of "build it and they will come" reigned in the investment heyday of the late 1990s. That investment for investment's sake strategy has been abandoned by the market. The Commission should learn the same lesson that the CLECs (painfully) were forced to learn.

2. The current market largely reflects correct economic signals

To the extent that the Commission seeks in this proceeding to "send[] efficient entry and investment signals to all competitors," the basic costing principles of TELRIC should not be changed. Competition is taking hold, the ILECs are for the first time having to stave off competitors on the merits rather than in the hearing room, and the capital markets are regaining their confidence in CLECs. It is thus clear that the market is generally getting the correct signals. The prevailing TELRIC rules should therefore not be dramatically altered or tinkered with extensively.

Studies show that ILEC investment ramped up in response to competitive threats, such as from CLECs using UNE-P and integrated T1 products. For example, a recent study found that ILECs increased their average per-line investment $759 for every UNE-P line they

[71] Conference Report at 148.

lease.[72] Thus, the empirical data demonstrates that cost-based unbundling signals carriers to invest (where prudent) – the result that the Commission wants to foster.

In addition, CLEC local market share, though not nearly enough to erase ILEC market power,[73] consistently climbs. In 2002, CLECs controlled 13.2% of access lines, or 24.8 million lines, up from 10.3% (21.6 million) in 2001.[74] Of these loops, an increasing number are UNEs (55%), and not resold (19%). Increasing use of UNEs translates to increased investment, as CLECs must purchase the equipment, such as switches, collocation equipment, and integrated access devices, to deliver innovative services over them. This migration to increased network investment was exactly the result Congress envisioned and hoped for.[75]

ILEC winback efforts also demonstrate that real merits-based competition is now a reality. Winback, though in certain forms highly questionable as a matter of competition law, has brought innovative service packages, lower rates, and other incentives to the local market. It is a direct response to the presence of successful CLECs, including parties to these comments.[76] If CLEC presence diminishes, so will the consumer benefits that result from ILEC winback

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[72] Willig at 3.11 (*citing* PHOENIX CENTER POLICY BULLETIN NO. 5: *Competition and Bell Company Investment in Telecommunications Plant: The Effects of UNE-P* (Jul. 9, 2003)).

[73] Although the courts have not derived a single figure for determining when market share becomes market power, a share exceeding 80% of a market, especially where there are high barriers to entry, will be deemed monopolistic. *See United States v. Grinnel Corp*, 384 U.S. 563, 571 (1966) (group of defendants have 87% market share held to have market power); *United States v. E.I. duPont de Nemours & Co*., 351 U.S. 377, 391 (1956) (75% share of cellophane wrap market deemed market power).

[74] *FCC Local Telephone Competition Report.*

[75] Conference Report at 148. ("[I]t is unlikely that competitors will have a fully redundant network in place when they initially offer local service, because the investment necessary is so significant.").

[76] McCausland Affidavit (Sage) ¶ 8 ("For example, SBC now has developed a winback promotion that provides free local and long distance service through bill credits – thereby emulating Sage's service packages. This type of head-to-head price competition, when associated with compliant wholesale access, is exactly what the 1996 Act was meant to achieve."); McKee Affidavit (XO) ¶ 7 ("The market has already seen significant competition. This fact is best illustrated by the recent "Winback" activities by ILECs, notably SBC and BellSouth."). Attached hereto in **Exhibit 2**.

efforts. Any major change to TELRIC that raises UNE prices is likely to bring that unwanted result.

The fact is that TELRIC is sending the correct signals to the market: if CLECs get truly cost-based UNEs (*i.e.*, at TELRIC), they will have the appropriate incentive to build more and reach farther, and the ILECs will have to respond. The ILECs are indeed responding, both on the merits and, unfortunately, in the regulatory arena. They are attempting to dismantle TELRIC precisely because it is working. If their monopoly ratebase were not at stake, the Commission's unbundling regime would not be under attack. And it is not only their existing ratebase that is at stake. It is also the potential revenue gained from leveraging their local market power into adjacent information services and long distance product markets that are in danger. The Commission should therefore "consider the source" of ILEC criticisms of TELRIC and evaluate those criticisms with the appropriate degree of skepticism.

E. ILECs Have Not Provided Any Evidence that UNE Rates Are Confiscatory Such that TELRIC Should Be Changed

Despite the Supreme Court's finding that the current TELRIC pricing rules provide the ILECs with an opportunity to earn a reasonable return on their investments, ILECs continue unabated with the rhetoric that wholesale prices for UNEs are below cost. Repetition does not make it so. Moreover, the *NPRM* appears to have a misplaced bias toward presuming that to the extent that errors may have been made in applying the TELRIC pricing methodology, those errors resulted in UNE rates that are too low.[77] The *NPRM* attempts to justify this presumption on the basis that although a benchmarking test has been used to constrain high UNE

[77] *NPRM* ¶ 28.

rates, no comparable process exists to identify or correct rates that are too low.[78] Such presumption completely ignores the fact that the Commission established a procedure in the *Local Competition Order* that provides the ILECs an opportunity to seek relief from the TELRIC pricing rules if they provide specific information to show that the pricing methodology, as applied to them, will result in confiscatory rates.[79] To succeed on such a claim the ILECs must demonstrate that TELRIC pricing "jeopardize[s] the financial integrity of the companies, either by leaving them insufficient operating capital or by impeding their ability to raise future capital."[80] Thus, ILECs currently may challenge UNE rates in advance of a rate order, but they must go beyond general criticism of the TELRIC methodology and show with specific information that a confiscatory rate is bound to result.

No ILEC has demonstrated that it is being required to operate at a loss or that it is being compelled to operate at an overall rate of return that is unconstitutionally low. Even focusing on the adequacy of the ILECs' compensation for leasing network elements in isolation, the ILECs have not offered a compelling reason to conclude that they are receiving compensation for network elements that is less than required by the statute. Moreover, there is no body of cases finding that state UNE proceedings have set rates too low. Further, state commission decisions concerning wholesale network pricing are based on an evidentiary record that is developed through public hearings, which are subject to review.

The Commission's acknowledgment of the potential for relief where confiscation can be specifically demonstrated (rather than merely asserted) undermines any suggestion that

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78 *Id.*

79 *Id.* ¶ 40 (citing to *Local Competition Order* ¶ 672) .

80 *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 312 (1989).

the current TELRIC pricing rules have produced or will produce confiscatory results in any circumstance. In addition, the Commission has not foreclosed the possibility of a remedy to recover embedded costs not recovered through UNE rates if the need for such a remedy is demonstrated.[81] However, the Commission explained that such a remedy would be implemented not through the rates that new entrants pay for network elements, but rather through a competitively neutral federal or state funding mechanism.[82]

The availability of this relief significantly diminishes, and in fact, should foreclose the need for the Commission to be concerned with whether TELRIC rates provide for full cost recovery. Should a state implement TELRIC in a manner that prevents full cost recovery, incumbents can appeal to the state, the Commission and the courts to reject these prices as confiscatory. At the very least, before accepting ILEC assertions that UNE rates are too low, the Commission must insist that ILECs provide in the appropriate forum specific information to support their claims.

Indeed, state commissions – the best experts on the complexities of TELRIC pricing – have found the rates to be a fair reflection of the costs ILECs face in leasing the various elements of their network, and that the rates provide the ILECs a fair return.[83] For example, New Jersey Board of Public Utilities President Jeanne M. Fox said that "[The ILECs] are making less money than they would like to make [but they] are still making a profit, and they are still making

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81 *NPRM* ¶ 40 (citing *Local Competition Order* ¶ 739).

82 *Local Competition Order* ¶ 739.

83 *See* Duane D. Freese, *TELRIC Like It Is*, TECH CENTRAL STATION.COM (Aug. 27, 2003), available at: http://www2.techcentralstation.com/1051/techwrapper.jsp?PID=1051-250&CID=1051-082703F

their costs."[84] The real issue is not that the rates derived under the current TELRIC pricing rules do not cover the ILECs' costs. The issue is that the rates do not provide ILECs the return they desire.

F. The Commission Cannot Reverse, Amend or Alter the TELRIC Rules Absent a Clearly Articulated Reason Based Squarely on the Record

According to the long-standing doctrine articulated in *State Farm*,[85] a decision by an administrative agency to modify an existing rule or policy must be "rational, based on the consideration of the relevant factors and within the scope of the authority delegated to the agency by the statute."[86] Thus, the Commission's decision in this proceeding must be rational in its assumptions as well as its conclusions.[87] And, any decision to significantly adjust the current TELRIC framework must be supported by more than a mere observation that circumstances in the telecommunications market have changed since the passage of the Act.

The Commission's TELRIC rules have been in place for several years, and have greatly advanced the pro-competitive objectives of the Act.[88] Any departure from these rules, or from the Commission's underlying regulatory policies, must be substantiated by tangible factual evidence demonstrating that the current TELRIC pricing framework no longer promotes competition in the market for telecommunications services. Thus, it will not be sufficient to simply assert a "concern" that TELRIC may "distort[] [the Commission's] intended pricing

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84 *Id.*

85 *Motor Vehicle Manufacturers Association of the United States v. State Farm Mutual Automobile Insurance Company*, 463 U.S. 29 (1983).

86 *State Farm*, 463 U.S. at 42-43. To effect a change of law or policy, a federal administrative agency must articulate the factual basis for its decision, and must address significant comments made in the rulemaking proceeding and reasonably obvious alternative rules. *State Farm*, 463 U.S. at 43.

87 *Citizens to Preserve Overton Park v. Volpe*, 401 U.S. 402, 414 (1971).

88 *See NPRM* ¶ 1 n.3.

signals;"[89] rather, the Commission must demonstrate an actual, quantifiable flaw in the current rules and cogently explain why any change is for the better, let alone necessary.

To be clear, the Commission's new policy of championing broadband to the detriment of all other technologies and services[90] – is ***not*** a sufficient reason to overhaul TELRIC. The advanced services goals of Sections 706 were never meant to supersede the core competitive goals in Sections 251 and 252. Indeed, the Commission itself found that "in light of the statutory language, the framework of the 1996 Act, its legislative history, and Congress's policy objectives, the most logical statutory interpretation is that *section 706 does not constitute an independent grant of authority*."[91] Accordingly, it held that "*we may not use that authority to forbear from applying the requirements of sections 251(c) and 271 prior to their full implementation*."[92] Moreover, the assertion that unbundling discourages deployment simply defies common sense and was soundly rejected by the Supreme Court.[93] The illusory broadband at the expense of all else mandate that the FCC perceives can therefore not be the fulcrum for changing TELRIC.

In sum, a decision by the Commission in this proceeding that dramatically alters its existing rules implementing Congress's Sections 251 and 252 pricing mandates may well

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89 *NPRM* ¶ 3.

90 *E.g.*, Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers, *Notice of Proposed Rulemaking*, 16 FCC Rcd. 22781, 22791-93 (¶¶ 22-23) (2001); *Report and Order and Order on Remand and Further Notice of Proposed Rulemaking*, FCC 03-36, ¶¶ 175, 178 (rel. Aug. 21, 2003) ("*Triennial Review Order*").

91 Deployment of Wireline Services Offering Advanced Telecommunications Capability, *Memorandum Opinion and Order*, 13 FCC Rcd. 24011, 24047 (¶ 77) (1998) (emphasis added) ("*Advanced Services Order and NPRM*").

92 *Id.*

93 *Verizon*, 535 U.S. at 517.

constitute action that is beyond the scope of the Commission's authority. The Commission could do no greater harm to the advancement of local competition – and broadband deployment – than ignoring Congress's pricing mandates in Section 252. While the Bells would like to undo Section 252, this rulemaking is not the appropriate forum and the Commission need not goad them into thinking that is.

IV. CONCLUSIONS REACHED IN THE *LOCAL COMPETITION ORDER* REGARDING TELRIC PRICING ARE STILL VALID TODAY

In 1996, to address a congressional mandate, the Commission adopted its *Local Competition Order*, to guide states in setting individual UNE rates.[94] In choosing the current TELRIC pricing standard, the Commission undertook a very deliberate and reasoned analysis that specifically took into account Congress's clear direction that the standard must depart from traditional rate-of-return or other rate-based setting practices (with their detailed examination of historical accounting costs and reliance on an embedded rate base), which the 1996 Act explicitly disavows.[95] The Commission's decisions in the *Local Competition Order* not only complied with the plain statutory language of the 1996 Act, but also advanced Congress's intent to promote efficient competition in local telecommunications markets.

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94 *Local Competition Order*, 11 FCC Rcd 15499.

95 Section 252(d)(1) directed that the rate than an ILEC may charge a new entrant for leasing a network element "shall be based on the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing the interconnection or network element (whichever is applicable), and . . . nondiscriminatory . . . and may include a reasonable profit." 47 U.S.C. § 252(d)(1).

A. *Local Competition Order* Pricing Decisions Were Made on Firm Footing Not Shared by Many of the Proposals Put Forth in the *NPRM*

As explained below, the conclusions reached in the *Local Competition Order* and the assumptions underlying those conclusions are still valid today and fully address the majority of the concerns raised in the instant *NPRM*.

First, in deciding the best approach for setting prices that best furthers the goals of the 1996 Act, the Commission determined that the cost of providing a network element is the forward-looking long-run economic cost of the element, not the historical costs that are recorded in the ILECs' accounting books *or forward-looking actual costs*, which the ILECs had sought.[96] In determining that the appropriate cost of providing a network is the forward-looking economic cost of that element, the Commission explained that a forward-looking methodology most closely replicates rational economic behavior in a competitive market.[97]

The Commission flatly rejected ILEC arguments that prices for unbundled network elements must or should include any difference between the embedded costs they have incurred to provide those elements and their forward-looking economic costs.[98] The

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[96] *Local Competition Order* ¶¶ 620-621.

[97] The FCC's conclusion that a pricing methodology based on forward-looking economic costs best replicates the conditions of a competitive market is particularly applicable to the telecommunications industry. As one court explained:

> For it is current and anticipated cost, rather than historical cost that is relevant to business decisions to enter markets and price products. . . . The historical costs associated with the plant already in place are essentially irrelevant to this decision since those costs are "sunk" and unavoidable and are unaffected by the new production decision. This factor may be particularly significant in industries such as telecommunications which depend heavily on technological innovation, and in which a firm's accounting, or sunk, costs may have little relation to current pricing decisions.

MCI Communications v. AT&T, 708 F.3d 1081, 1116-1117 (7th Cir.), *cert. denied*, 104 S.Ct. 234 (1998).

[98] *Local Competition Order* ¶ 705.

Commission explained that the problem with a method that relies on "the costs reflected in the regulated books of account [or] a price based on forward looking costs plus an additional amount reflecting embedded costs," which is the cost the ILECs allege they actually incur in leasing network elements, is that it will pass on to entrants the difference between most-efficient cost and embedded cost.[99] Such cost differences reflect past inefficiencies, whether caused, for example, by poor management resulting in higher operating costs or poor investment strategies that have inflated capital and depreciation expense. Accordingly, if the Commission permitted network elements to be priced according to embedded costs, the ILECs could pass the inefficiencies to competitors, and to that extent defeat the competitive purpose of forcing efficient choices on all carriers whether incumbents or entrants. The result would be higher retail prices, less competition and less investment.[100]

In the *Local Competition Order*, the Commission correctly determined that a principal goal of the 1996 Act was to remove the economic impediments that inefficiently retard entry.[101] In support of that goal, the Commission determined that the local competition provisions of the 1996 Act require that the ILEC scale and scope economies be shared with entrants and that ILECs should share their networks in a way that permits the ILECs to maintain operating efficiency to further fair competition, and to enable the entrants to share the economic benefits of that efficiency in the form of cost-based prices.[102] Allowing recovery of embedded

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99 *Id*.

100 *Id.* ¶ 679.

101 Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, *Notice of Proposed Rulemaking*, 11 FCC Rcd. 14171, 14177 (¶ 12) (1996).

102 *Local Competition Order* ¶ 11.

costs would not create any incentive for ILECs to maximize their network and operational efficiencies.

Further, the Commission found that basing the rates for access to network elements on the ILECs' historical costs, when those costs exceed forward-looking costs, would either keep new entrants out of the market altogether or impair their competitive position by inducing them to construct inefficient, duplicative facilities, with no commensurate increase in the value or diversity of telecommunications services.[103] The Commission concluded that either result would conflict with Congress's twin goals of bringing meaningful competition to the local markets and enabling new entrants to make efficient use of existing network facilities, many of which embody enormous economies of scale and density.[104] Additionally, the Commission determined that adopting a forward-looking cost methodology would reduce the ability of an ILEC to engage in anticompetitive, strategic or discriminatory pricing by manipulating the cost of individual rate elements.[105] In sum, the Commission determined that adopting a forward-looking methodology based on forward-looking economic (rather than actual) costs would send appropriate signals for entry, investment, and innovation to potential competitors in local telecommunications markets.

Second, the Commission addressed the so-called hypothetical nature of TELRIC and concerns that TELRIC does not sufficiently account for the "real world" attributes of the existing telecommunications network, particularly the routing and topography of the ILEC's existing network. The current TELRIC pricing standard requires that rates be based on the use

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103 *Id.* ¶¶ 679, 705.

104 *Id.* ¶¶ 679, 704-707.

105 *Id.* ¶ 679.

of the most efficient telecommunications technology currently available and the lowest cost network configuration, given the existing location of the ILECs' wire centers.

As a preliminary matter, in the *Local Competition Order*, the Commission rejected the claim that "the information required to compute prices based on forward-looking costs is inherently so hypothetical as to be of little or no practical value," noting that the TELRIC methodology is based on similar, and similarly hypothetical, forward-looking costing methodologies that had been implemented or supported by several state public utility commissions to set prices for UNEs, some for many years.[106] It is also worth noting that during the period from 1996 through early 1999 when the Commission's TELRIC pricing rules were stayed and then vacated by the Eighth Circuit on jurisdictional grounds, the majority of state public utility commissions independently and voluntarily embraced the essentials of TELRIC, including its consideration of efficient available alternatives, in their implementation of the local competition provisions of the 1996 Act.

Given the critical assumption that a forward-looking methodology most closely replicates rational economic behavior in a competitive market (an assumption that the Commission states that it is committed to preserving in this proceeding[107]), the Commission carefully examined in the context of three general approaches, whether, under a forward-looking cost methodology, costs should be computed based on the least-cost, most efficient network configuration and technology currently available, or whether forward-looking cost should be

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106 *Id.* ¶¶ 631, 681 (noting that TELRIC-like methodologies had been adopted or were supported by public utility commissions in Arizona, California, Colorado, Connecticut, Florida, Louisiana, Maryland, Michigan, Missouri, Oklahoma, Texas and Wyoming).

107 *NPRM* ¶ 37.

computed based on the ILECs' existing network infrastructure, taking into account changes in depreciation and inflation.[108]

Under the first approach, the Commission analyzed the forward-looking cost for UNEs based on the least-cost, most efficient network design that is operationally feasible and currently available. This approach would replicate conditions in a highly competitive marketplace by not basing prices on existing network design and investments unless they represented the least-cost systems available for purchase.[109] The Commission rejected this approach after concluding that it might encourage entrants to rely on the ILECs' facilities and discourage new investment by all firms in the industry.[110] In other words, unlike the TELRIC standard that was adopted, this approach did not tolerate any ILEC network inefficiencies.

Under the second approach, the Commission analyzed the forward-looking cost for UNEs based on the existing network design and technology that currently are in place (the cost of using real world attributes of the ILEC's existing network, *i.e.*, the tentative conclusion in the *NPRM*).[111] Because this approach is not based on a hypothetical network in the short run, this approach would permit ILECs to recover costs on their existing operations. Accordingly, under this approach, prices for UNEs would reflect inefficient or obsolete network design and technology. The Commission therefore rejected this approach finding that it was essentially an embedded cost methodology. (As the *NPRM* acknowledges, the statutory language places a

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108 *Local Competition Order* ¶ 683.

109 *Id.*

110 *Id*.

111 *Id.* ¶ 684.

heavy presumption against using an embedded cost methodology,[112] and the Supreme Court indicated that an argument could be made that such a method is illegal[113]). In other words, adopting a price for UNEs based on actual costs, which reflects an ILEC's actual inefficient behavior, will lead to prices that overstate economic costs and send inefficient entry signals. Such an approach also would defeat the competitive purpose of forcing efficient choices on all carriers whether incumbents or entrants.

Under the third approach, the Commission analyzed the forward-looking costs for UNEs based on the most efficient technology deployed in the ILEC's current wire center locations.[114] The Commission concluded that this approach (i) most closely represents the incremental costs that ILECs actually expect to incur in making network elements available to new entrants, (ii) encourages facilities-based competition to the extent that new entrants can design more efficient network configurations and are thus able to provide the service at a lower cost than the ILEC; and (iii) should facilitate competition on a reasonable and efficient basis by all firms in the industry.[115] Moreover, the Commission found that this approach would mitigate ILEC concerns that a forward-looking pricing methodology ignores existing network design, while basing prices on efficient, new technology that is compatible with the existing infrastructure.

The Commission thus concluded that the forward-looking pricing methodology should be based on costs that assume that wire centers will be placed at the ILEC's current wire

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112 *NPRM* ¶ 33.

113 *Verizon*, 535 U.S. at 512.

114 *Local Competition Order* ¶ 685.

115 *Id*.

center locations, but that the reconstructed local network would employ the most efficient technology for reasonably foreseeable capacity requirements. In adopting this approach, the Commission determined that the most appropriate way to deal with the real world in determining the forward-looking costs of network elements is to consider the cost of any efficient alternatives currently available on the market (not just alternatives that are physically identical to the facilities currently in place), rather than to pretend that they do not exist.[116] Indeed, a forward-looking cost inquiry that does not take into account the costs of efficient available alternatives would, like a historical cost inquiry, produce rates that turn on choices that a particular ILEC made in the past about which equipment to install or when to install it. The Commission thus rejected the argument that the forward-looking inquiry should turn on the cost of replicating an ILEC's existing facilities in every physical aspect, recognizing that such an approach could produce rates that reflect inefficient or obsolete network design and technology. While TELRIC has many similarities with rate-of-return regulations, it does not base a firm's UNE prices on the firm's own actual behavior, thereby giving the ILECs a powerful incentive to minimize costs.

Third, the current TELRIC methodology does not presuppose, as the *NPRM* suggests,[117] that firms will replace all network assets instantly and simultaneously once more efficient technologies are deployed. Contrary to being "perhaps the most controversial aspect of the TELRIC rules,"[118] as the *NPRM* contends, this claim was addressed and rejected in the *Local*

116 *Id.* ¶¶ 672-707.

117 *NPRM* ¶ 50.

118 *Id.* ¶ 49.

Competition Order,[119] as well as by the Supreme Court in the *Verizon* decision[120] and by the Wireline Competition Bureau (the "Bureau") in the *Virginia Arbitration* proceeding.[121]

Moreover, TELRIC does not, in fact, require replacement of the network at all in one important sense. A new entrant entering the market with the luxury of serving all existing ILEC customers certainly would not place wire centers in the same location as the ILEC did decades ago. Yet, the TELRIC methodology requires the cost study model to assume that wire centers will be placed at the ILEC's current wire center locations. Thus, the TELRIC methodology is already a compromise that freezes in time perhaps the most significant driver of loop costs – where loops start.

B. The Central Purpose of the Act Is to Affirmatively Promote Efficient Competition Using the Three Modes of Entry Provided by Congress – Not Simply to Promote Full Facilities-Based Competition at the Expense of Other Methods of Entry Such as UNE-Based Entry

The evident bias against UNEs in the *NPRM* as a viable entry vehicle is inconsistent with the 1996 Act and contradicts the Commission's prior findings. As the Commission determined in the *Local Competition Order*, the Act requires that ILECs allow a

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[119] *Local Competition Order* ¶ 688.

[120] As the Court explained, apart from the explicit limitation imposed in the TELRIC standard, the fact that in practice wholesale TELRIC rates are set by state public utility commissions in generic arbitration proceedings imposes an additional and very real limitation on the ability of the rates to account for instantaneous improvements in technology. *Verizon*, 535 U.S. at 502. The three to four year period between proceedings creates a built-in lag in TELRIC price adjustments. Thus, the concerns in the *NPRM* about the need to impose an objective time horizon to constrain technological evolution to a given period are already addressed by the built-in lag. *NPRM* ¶ 54.

[121] In the *Virginia Arbitration*, the Bureau explained that it interpreted the requirement

> to use the "most efficient technology currently available" to mean that the incumbent LEC and its competitors will deploy current technology over a period of time and, in the long run, this technology will be deployed ubiquitously.

Petition of WorldCom, Inc., Pursuant to Section 252(e)(5) of the Communications Act for Preemption of the Jurisdiction of the Virginia State Corporation Commission Regarding Interconnection Disputes with Verizon Virginia Inc., and for Expedited Arbitration, *Memorandum Opinion and Order*, 18 FCC Rcd. 17722 (2003) ("*Virginia Arbitration*").

competitor to enter the local exchange market in one of three ways: build its own local access network; buy the ILEC's local services at wholesale and re-brand it for retail sale; or create a hybrid network that combines some of the entrant's facilities with unbundled network elements that are acquired from the ILEC.[122] Recognizing that the 1996 Act "required it to implement rules that eliminate statutory and regulatory barriers and to remove economic impediments," the Commission found that

> Section 251 neither explicitly nor implicitly expresses a preference for one particular entry strategy. Moreover, given the likelihood that entrants will combine or alter entry strategies over time, an attempt to indicate such a preference in our section 251 rules may have unintended and undesirable results. Rather, our obligation in this proceeding is to establish rules that will ensure that all pro-competitive entry strategies may be explored.[123]

While most of the CLEC TELRIC Coalition are facilities-based carriers to varying extents, the notion that the 1996 Act has a preference for facilities-based entry is a fiction sold by the ILECs and bought by too many at the Commission.

Also implicit throughout the *NPRM* is a preference for intermodal[124] competition and the accompanying concern that the pre-*Triennial Review Order* unbundling requirements and current TELRIC pricing rules impede the development of intermodal competition. Notwithstanding the articulated preference of some to promote intermodal competition, it is clear from the three paths of entry contemplated by Section 251 – the construction of new networks, the use of unbundled network elements, and resale – that Congress was seeking to open the

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122 *Local Competition Order* ¶ 12.

123 *Id*.

124 In the *Triennial Review Order*, the FCC explained that by "intermodal" it "refer[s] generally to facilities or technologies other than those found in traditional telephone networks. These include, for example, traditional or new cable plant, wireless technologies (satellite, mobile, and fixed), power line (electric grid) technologies, or other technologies not rooted in traditional telephone networks." *Triennial Review Order* n.325.

ILECs' local exchange markets to competition primarily through intramodal (*i.e.*, wireline) competition. The unbundling provisions are a cornerstone of the 1996 Act. Unbundling is necessary to mitigate the ILECs' ability to exercise market power in the local exchange market, and because installing facilities, particularly the "last mile" transmission facilities is so expensive, unbundling allows entrants time to build their own back office systems and to create sufficient demand to warrant the construction of competitive networks.

The *NPRM* reflects a mistaken belief that by facilitating the offering of multiple modes of entry into the local telecommunications market by intermodal service providers the Commission will have done enough to achieve the pro-competitive goals of the 1996 Act. Congress, however, was not satisfied with wireline monopolies – and neither was the consuming and voting public.[125] Seven years later, Congress and consumers have not changed their minds. At this stage, it remains the case that the only competitors that have deployed facilities on a ubiquitous basis are the ILECs, which remain dominant in the local exchange market. Surely local cable and power companies (still typically monopolies) may develop into intermodal competitors capable of challenging the ILECs in certain service and market segments. Wireless also holds promise and may some day be a more effective competitor to wireline services.

However, none of the intermodal competitors provides effective competition across the local exchange market today and it remains to be seen whether any ever will. Thus, it cannot be lost that the primary purpose of the 1996 Act is to open the local exchange market to wireline competition (hence, the interconnection and unbundling requirements). The Supreme

[125] To say one wireline provider is enough is the equivalent of saying one airline is enough, because people can also take a train, ride a bus, drive a car, or walk from New York to Los Angeles. In the end, consumers will get the short end of that thinking. One airline per market is not enough and neither is one provider of wireline services.

Court in *Verizon* expressly found that the notion of intermodal competition is weak, at best, and that consumers generally do not view the other technologies as close substitutes for the ILECs' local exchange market under current and foreseeable market conditions.[126] As such, undue reliance on intermodal competition will not promote competition in the local exchange market and consumer welfare will not improve. Moreover, because the intermodal competitors are often monopolies in their respective services, by definition they have imperfect incentives to deploy new and technology and little incentive to compete fully.

C. TELRIC Promotes Efficient Investment – Not Investment for Investment's Sake

The telecommunications industry went through a period of extremely rapid growth in the late 1990s. Some competitors entered the local exchange market based on the wishful philosophy of "build it and they will come." As discussed above, this investment strategy was not sustainable and it eventually was abandoned by Wall Street. When Wall Street reversed its investment approach, it contributed to an industry-wide meltdown, to which only the ILECs seemed relatively immune.

Notably, the Commission in its *Local Competition Order*, did not favor an investment for investment's sake strategy. Instead, the Commission correctly favored an efficient investment approach which involves investment at the right place and time. To this end, the Commission acknowledged that in most markets, entrants cannot achieve sufficient economies of scale, scope or density to warrant making the tremendous capital investment

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[126] *Verizon*, 535 U.S. at 521, n.35; *see also* Lawrence J. Spiwak, *The Telecoms Twilight Zone: Navigating the Legal Morass Among the Supreme Court, the D.C. Circuit, and the Federal Communications Commission*, PHOENIX CENTER POLICY PAPER SERIES NO. 13 (August 2002) at 6, 14-15 (*available at*: http://www.phoenix-center.org/pcpp?PCPP13Final.pdf).

required to build various components of the local exchange network from the ground up without building revenues and a customer base first.[127] The Commission found that access to TELRIC priced network inputs in such instances promotes efficient investment and competition for local exchange services because such access will allow new entrants to enter local markets by obtaining use of the ILEC's facilities at prices that reflect the incumbent's economies of scale and scope.[128] Accordingly, the Commission recognized that for each market, entrants must make a fundamental decision regarding the most efficient mix of TELRIC priced facilities and self-supplied elements.[129]

Today, that conclusion remains sound. Entry into the local exchange market, even when heavily dependent on ILEC UNEs, remains very capital intensive. Beyond the significant investment in network and equipment, entrants must invest substantial funds to build operational support systems ("OSS"), develop and implement marketing and sales strategies for customer acquisition and retention, create billing systems, negotiate interconnection agreements, and monitor regulatory proceedings. Large fixed and sunk costs such as these raise the risk of entry and necessitate a relatively large customer base to realize sufficient scale economies to effectively compete with the ILEC and survive. Thus, reliance on TELRIC-based inputs continues to allow CLECs to grow while making efficient investment choices.

Under the current TELRIC pricing rules a CLEC may embark on a strategy that allows it to first develop a customer base and gradually build out certain self-supplied elements

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127 *Local Competition Order* ¶ 232.

128 *Id.*

129 *Id.* ¶ 12 (finding that "new entrants will follow multiple paths of entry as market conditions and access to capital permit").

as conditions warrant.[130] The proposal in the *NPRM* to shift to permit ILECs to recover embedded costs in the prices they charge competitors for UNEs, while ILECs experience much lower incremental costs, will result in inefficiently high prices that will either cause new entrants to over-build existing systems instead of maximizing the efficient use of the existing ILEC networks, or discourage entry and investment in local markets altogether. The Commission must ensure that any modifications to the current TELRIC pricing rules it adopts avoids that result and continues to support economically efficient investment that provides tangible benefits to the economy as a whole and to consumers.

V. THE COMMISSION MUST BE CAREFUL NOT TO ROLL-BACK CONSUMER BENEFITS USHERED IN BY UNE-BASED COMPETITION

The *NPRM* contains a disturbing and unfounded bias in favor of *higher* UNE prices and the investment signals such prices will send. Lost in the virtual non-issue of investment that pervades the *NPRM* is how all of what the Commission is considering may impact consumers. The 1996 Act was intended to bring tangible benefits to consumers and UNE pricing in particular was intended to make portable to consumers the benefits of the ILEC scale and scope[131] – benefits that continue to accrue to every ILEC investment to this day. Accordingly, the Commission cannot simply turn a blind eye to the impact of this rulemaking on consumers.

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[130] As the Commission previously recognized, because the current TELRIC standard incorporates certain ILEC efficiencies, it would be inefficient for the CLEC to remain dependent on the ILEC facilities indefinitely. *See Local Competition Order* ¶ 685.

[131] *Local Competition Order* ¶ 679.

A. Any Rule Changes Should Promote Consumer Welfare

Congress had a very clear objective in mind when it decided to enable CLEC entry: to bring the benefits of effective competition to consumers of local telephone service.[132] As the Commission has acknowledged, a vibrantly competitive local telecommunications market best serves consumer welfare.[133] Given that the fundamental objective of the 1996 Act was to improve consumer welfare, it is especially troubling that the *NPRM* fails to address the impact that its tentative conclusion and other changes considered might have on consumer welfare. Indeed, it is alarming that the *NPRM* fails to address the potential loss of consumer welfare that would result if the Commission adopts its tentative conclusion or otherwise makes changes to the TELRIC pricing rules suggested by the ILECs and their allies.

Regardless, the ultimate goal of any action the Commission takes in this proceeding should be to improve consumer welfare in a manner consistent with the choices already made by Congress. Congress already has decided that the best way to improve consumer welfare is to require pricing that promotes competitive entry. The current TELRIC pricing rules have been a critical factor in encouraging and sustaining competitive entry. Indeed, most of the local competition today relies to some extent on TELRIC-priced UNEs. As the Commission recognized in the *Local Competition Order*, CLECs using UNEs as a method of entry have greater opportunities to package and offer services that are different from those offered by the ILECs, which increases a CLEC's ability to compete effectively against the ILEC which, in turn,

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[132] House Report at 1 (goal of the 1996 Act is "to promote competition and reduce regulation in order to secure lower prices and higher quality services for American telecommunications consumers").

[133] *See UNE Remand Order*, 15 FCC at 3700 ¶ 5 ("The standards and unbundling obligations that we adopt in this Order are designed to create incentives for both incumbent and competitive LECs to innovate and invest in technologies and services that will benefit consumers though increased choices of telecommunications services and lower prices.").

benefits consumers.[134] DSL, integrated T1s, bundled service offerings, and advanced vertical features are all innovations driven by CLECs using TELRIC-priced UNEs and delivering real tangible benefits to consumers (whether through their own service offerings or through responsive ILEC service offerings). Thus, before adopting any of the proposed modifications to TELRIC, the Commission must quantify and explain how such changes will result in increased consumer welfare.

B. TELRIC Prices in Excess of Economic Costs Will Curb Competition and Eliminate Consumer Benefits

The goal of bringing the benefits of a competitive local exchange market to consumers will not be realized by adopting policies that generally will increase the rates that CLECs pay for UNEs. As one recent study found, wholesale prices that exceed appropriate TELRIC levels can raise the cost of retail phone service and reduce investment by discouraging competition.[135] Specifically, the study found that in cases where UNE prices were set above the appropriate TELRIC level "can actually end up raising voice prices, lowering demand for telecom services, and reducing telecom investment . . ."[136] Thus, if UNE prices are set too high, competitors will be unable to provide certain services economically to consumers and many market segments. Competitors will either decline to enter the market or be forced to abandon certain product offerings or leave certain markets altogether. Increased UNE prices that drive competitors from the market obviously do not produce long-term gains for consumers and therefore do not improve consumer welfare. In contrast, states that have rigorously applied

134 *Local Competition Order* ¶ 333.

135 *Increased Investment* at 3.

136 *Id.* at 6.

TELRIC principles to produce lower UNE rates have seen a significant increase in UNE-based competition, and their residents have seen their local phone bills drop by as much as one third.[137]

Indeed, local competition has been fostered by states' application of TELRIC, with penetration generally being greater in states that applied TELRIC principles more rigorously.[138] And, despite their rhetoric, the ILECs have not been harmed by such pricing. The fact is that the ILECs continue to report healthy if not record profits.[139] Recent analyses also show that UNE pricing is profitable for the ILEC, however not as profitable as the monopoly rents that ILECs could charge in the absence of current TELRIC pricing rules.[140] Moreover, application of TELRIC has not suppressed investment. In the late 1990s, ILEC investment was exploding in response to CLEC investment – all in markets with TELRIC-priced UNEs available.[141] This clearly demonstrates that competition drives investment. More importantly, however, competition, whether based on facilities investment, UNEs or resale (or any combination thereof), drives consumer welfare.

Nevertheless, in this proceeding, the Commission is considering a host of changes to TELRIC that could result in the setting of UNE prices well above economic cost. If UNE

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137 *Id.* at 3.

138 For example, competition is deepest in New York and Michigan where state public utility commission have endorsed and rigorously applied TELRIC principles to UNE pricing. *See FCC Local Telephone Competition Report*, Table 6.

139 *See, e.g.*, Walt Blackwell, "UNE Pricing: Facts & Fictions" (November 2002) (*available at*: nttp://www.phoneplusmag.com/articles/2b1soap.html).

140 *See, e.g.*, i2 Partners L.L.C., *Investor Outlook: FCC Triennial Review – Much Ado About Little* (February 2003) (ILEC EBITDA margins at UNE rates are "not negative") *available at:* www.i2partners.com/Downloads/i2_FCCTriennialReview_Feb03.pdf; George S. Ford, PhD and T. Randolph Beard, *Phoenix Center Policy Paper Number 16: What Determines Wholesale Prices for Network Elements in Telephony? An Econometric Evaluation* at 4, 21, Phoenix Center for Advanced Legal and Economic Public Policy Studies (September 2002) *available at:* http://www.phoenix-center.org/pcpp/PCPP16.pdf

141 *Increased Investment* at 5-8, 48 (Table 1).

prices are allowed to exceed economic cost (as proposed), competitive service offering prices likely will need to follow UNE prices upward (especially if CLECs are to meet forecasts for turning EBIDTA and cash flow positive).[142] Yet, ILEC retail prices need not follow and, as a result, they will be subject to less competitive pressure than before. And, to the extent UNE pricing exceeds comparable ILEC retail pricing, UNEs are rendered useless as a means of porting the benefits of incumbency to those consumers who choose to leave their incumbent carrier. Notably, this outcome inhibits not only a pure UNE approach, such as UNE-P, but it also threatens the UNE-L approach and is likely to result in the stranding of CLEC investments in switches and fiber rings. Without effeciently priced UNEs, end user product offerings that can be successfully provisioned over such facilities become severely constrained.

Thus, UNE price increases may force CLECs to abandon some service offerings or even entire markets (typically down-market and mass market segments) that cannot be served profitably at a rate that is competitive with the ILEC retail rate for comparable service offerings. The challenge the Commission faces is to ensure that UNEs are not rendered unusable by its decisions in this proceeding and that consumers are not forced back into the hands of ILECs with little or no incentive to improve service offerings and value. Otherwise, consumers will be left with nothing, as it is competition – and not protection from TELRIC-priced UNEs – that yields tangible consumer benefits and increased consumer welfare overall.

[142] The Commission needs to be mindful that to date in the TELRIC era, it has been the ILECs and not the CLECs that have been amassing record profits. Claims of impending doom made by the Bells in particular are so unbelievable that they should cast a presumption of doubt upon every submission made by them.

VI. ANY CHANGES TO TELRIC MUST BE INCREMENTAL TO MINIMIZE LITIGATION, REGULATORY UNCERTAINTY AND HARM TO CONSUMERS

Adopting fundamental changes to the TELRIC methodology, particularly given the changes to UNE regulation now in play because of the *Triennial Review Order* and the realities of the regulatory process, will only ensure that there will be more litigation and more uncertainty, and less competition and fewer consumer benefits.[143] This is no small matter and it should be given substantial weight in considering the value of any change to the existing TELRIC rules.

Changing the basis for pricing UNEs at this stage will inevitably result in variations in interpreting the changes and thus will spur a new outbreak of litigation in the courts and in each state.[144] The years of additional litigation, which would be resource-intensive and monumentally complex,[145] would be a major step backwards and inject substantial insecurity and uncertainty in the already less-than-robust competitive market.[146] As the Commission is keenly aware, regulatory uncertainty impedes competition. It recognized this fact in both the *Local Competition Order*[147] and the *UNE Remand Order*.[148] Indeed, the Commission flatly stated in the *UNE Remand* that it would not entertain intermittent "petitions to remove elements from the list," because even scant attention to such maneuvers "would threaten the certainty that we

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143 *See Murray-Cratty Declaration* ¶¶ 22, 34, 40.

144 *See id.* ¶ 34.

145 *See id.* ¶¶ 35-39.

146 *Id.* ¶¶ 40.

147 *Local Competition Order* ¶ 114 ("Failure to adopt national pricing rules could … create great uncertainty for the industry, capital market, regulators and courts … frustrating the potential entrants' ability to raise capital.").

148 *UNE Remand Order*, 15 FCC Rcd. at 3766 (¶ 150) ("[T]he rules we adopt today seek to provide a measure of certainty to ensure that new entrants and fledgling competitors can design networks, attract investment capital, and have sufficient time to attempt to implement their business plans.").

believe is necessary to bring rapid competition to the greatest number of consumers."[149] In fact, in the instant proceeding the Commission has expressed concern about the negative consequences of "[t]he lack of predictability in UNE rates."[150] Yet the proposed fundamental revamping of TELRIC is squarely at odds with this fundamental concern.

Moreover, as acknowledged in the *NPRM*, the proposed changes to TELRIC have the potential to create "undue advantages" for the ILECs,[151] which would dismantle competition and result in increased retail rates. The Commission's implementation of the 1996 Act requires that it eliminate "barriers to entry," not create or maintain them.[152] This includes requiring ILECs to disgorge the "economies of scale,"[153] or, as the Supreme Court put it, the "almost insurmountable competitive advantage,"[154] that the ILECs enjoy by virtue of their control over bottleneck local facilities. The *NPRM* seems to forget the ILECs' "insurmountable competitive advantage," and nowhere acknowledges that the 1996 Act envisioned that the vast economies of scale that the ILECs still enjoy were to be made available to the CLECs and their customers. These concepts were fundamental to creation of the current TELRIC pricing rules.

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149 *Id*.

150 *NPRM* ¶ 7. *See also NPRM* ¶ 9 (Commission seeks "to provide more certainty and consistency in the results of these state proceedings.").

151 *Id.* ¶ 52 ("Yet we also wish to ensure that a reformed TELRIC methodology does not swing in the other direction and give incumbents undue advantage.").

152 The House Report on the 1996 Act found that the ILECs "have historically been protected from competition by State and local government barriers to entry," in effect creating "government-sanctioned monopoly status" and conferring "bottleneck control over the essential facilities needed for the provision of local telephone service." House Report at 49.

153 *UNE Remand Order*, 15 FCC Rcd. at 3703 (¶ 13).

154 *Verizon*, 535 U.S. at 490.

The current TELRIC rules are producing generally desirable results.[155] States have worked with TELRIC or similar forward-looking economic cost methodologies since 1996 and understand better than ever how to implement it.[156] Moreover, the Commission only recently clarified its guidelines for the cost of money and depreciation (two of the most basic TELRIC inputs) in the *Triennial Review Order*. As neither the *Triennial Review Order* impairment proceedings nor any reevaluation of cost of money and depreciation rates has been implemented, it is impossible to gauge their effect if layered on top of any change to the TELRIC guidelines that may be adopted in this proceeding.[157] As our experts astutely observes,

> the Commission is now in a position something akin to a chef who has already determined to alter a cake recipe by cutting in half both the sugar and molasses and is now determining whether to eliminate the flour as well – without even having a chance to taste the result of the prior modifications. In regulation as in pastry, it is typically best to vary ingredients incrementally, checking the result as you go. Otherwise, one may suddenly find oneself with an unpalatable mess, with no clear remedy other than to start over from the very beginning.[158]

Given the high potential cost of changing the existing TELRIC guidelines, it is imperative that the Commission avoid underestimating that making any substantial change to the TELRIC guidelines at this time will likely increase market uncertainty and harm the development of the types of competition that the 1996 Act sought to establish.

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155 *See Murray-Cratty Declaration* ¶ 46.

156 *See id.* ¶ 33.

157 *See id.* ¶ 44-45.

158 *Id.* ¶ 45.

The Commission has been on the right track with its TELRIC methodology.[159] At most there may been a handful of conceptual issues that merit closer examination to ensure the proper application of forward-looking costing principles.[160] While the existing rules may need to be refined in some respects, they do not need to be recreated. Therefore, to the extent that the Commission proceeds to make adjustments to improve TELRIC, it must be committed to adopting an incremental and even-handed approach.

Finally, the Commission must acknowledge that changing TELRIC even in incremental ways may have a potentially significant effect on other pricing policy matters. Were the Commission to make changes to TELRIC, either in the underlying costing theory or evidentiary requirements, it likely would necessitate fundamental changes in the ongoing (if not perpetual) universal service and inter-carrier compensation proceedings. Reporting, accounting and separations rules also may need substantial revisions. Thus, the Commission will need to reconcile its costing methodology decisions in this proceeding with those made in other contexts. That process will open up a new round of debates and will further the current reign of regulatory instability.

VII. THE GOALS IDENTIFIED IN THE *LOCAL COMPETITION ORDER* SHOULD REMAIN THE PRIMARY GOALS OF THE COMMISSION'S UNE PRICING RULES

As the *NPRM* acknowledges, the *Local Competition Order* set forth two goals for UNE pricing: (1) "UNE prices should be set in a manner that sends efficient entry and investment signals to all competitors;" and (2) "UNE prices should provide incumbent LECs an

159 *See Murray-Cratty Declaration* ¶ 25.

160 *Id.* ¶ 25.

opportunity to recover the forward-looking costs of providing UNEs."[161] These goals should not be altered. As explained above, the Commission has appropriately determined that TELRIC is the forward looking methodology best suited to meeting these goals. Also as stated previously, changes to the TELRIC rules should be incremental and balanced, rather than monumental and driven toward a selected result. Thus, one of the most critical tasks for the Commission in this proceeding will be to fend off proposals that effectively dilute the "forward-looking" nature of its TELRIC methodology. Further dilution of the forward-looking nature of TELRIC will move the Commission further away from its stated goals. The Commission also should promote the goals of ensuring transparency and verifiability. Finally, any rule changes adopted by the Commission should not result in a loss of consumer welfare gains arrived at through UNE-based competition.

A. Changes to TELRIC that Are Inconsistent with a Forward-Looking Methodology Will Not Serve the Commission's Stated Goals

In the *NPRM*, the Commission renews its commitment to a forward-looking pricing methodology.[162] The CLEC TELRIC Coalition fully supports that conclusion and urges the Commission to guard against proposals that would dilute the forward-looking aspects of its current TELRIC pricing rules. Movement away from forward-looking pricing principles rewards inefficiency, fails to produce appropriate investment signals and diminishes consumer welfare.

In stark contrast to its stated commitment to a forward-looking pricing principles, the Commission also seeks comment on a number of proposals practically, if not fundamentally, at odds with what it means to be "forward-looking". For example, proposals that point toward the use of "actual" or "current" costs and inputs are most likely to be at odds with a forward-

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161 *NPRM* ¶ 38 (citing *Local Competition Order* ¶ 672).

162 *Id.* ¶ 37.

looking approach. Accordingly, the Commission must measure each proposed change for consistency with forward-looking pricing principles. In so doing, it may be useful to begin by recognizing what is **not** forward-looking and by affirming that such proposals will not become part of the Commission's Section 252 pricing rules.

Forward-looking is not historical cost. The ILECs' chief argument to the *Verizon* Court was that, while the term "forward-looking" is not necessarily outside the realm of reason under Section 252, it was improper for the Commission not to consider "the incumbent's past investment" when determining the TELRIC cost of the network.[163] The Supreme Court soundly rejected this argument, stating that "[a]t the most basic level of common usage, 'cost'" does not include past investment. "The cases have never assumed a sense of 'cost' as generous as the incumbents seem to claim."[164] The Court therefore held that cost must be "untethered to historical valuation."[165]

The Commission must therefore continue to reject any principle that entails, either directly or indirectly, the notion that ILEC historical should be recovered.[166] This would include the proposal to use "a comparison to an incumbent LEC's historical costs."[167] Comparing rates to historical cost presumes that historical cost is a relevant or appropriate yardstick of cost. It is not. Even examining historical costs in this way would imbue them with legitimacy, and skew the analysis of this Commission and of State Commissions toward pre-1996 Act rate-of-return

163 *Verizon*, 535 U.S. at 498.

164 *Id*. at 498-99.

165 *Id*. at 499.

166 *See NPRM* ¶¶ 32-33.

167 *Id*. ¶ 40.

thinking. The Commission therefore should not view historical costs as a "useful measure of whether UNE rates are providing an appropriate level of cost recovery."[168]

Forward-looking is not book value. The Supreme Court made clear in *Verizon* that book value is antithetical to Section 252's pricing mandate, as it is a notion out of pre-1996 Act utility pricing. In fact, even prior to the 1996 Act, use of book values was disfavored. The Court noted that under "traditional cost-of-service" methodology, "even when investment was wholly includable in the rate base, ratemakers often rejected the utilities' . . . book-value estimates."[169] At best, book value is synonymous with "embedded cost."[170] Accordingly, book value has no place in TELRIC or any other forward-looking methodology.

Forward-looking is not embedded cost. For the same reasons, embedded costs should not be included in TELRIC methodology either expressly or implicitly. Again, embedded costs have long since been rejected for utility ratemaking, even under the pre-1996 Act "prudent investment" costing rules.[171] The Supreme Court easily dispensed with the ILECs' plea to use embedded cost within TELRIC, stating that "[i]t would also be a mistake to forget that 'cost' was a term in value-based ratemaking and has figured in contemporary state and federal ratemaking ***untethered to historical valuation***."[172]

In the attached declaration, experts Murray and Cratty strongly oppose a rule that permits recovery of embedded costs: "To the extent that an ILEC's 'actual' embedded costs

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168 *Id.*

169 *Verizon*, 535 U.S. at 499.

170 *Id*.

171 *Verizon*, 535 U.S. at 499 ("'Cost' as used in calculating the rate base under the traditional cost-of service method did not stand for all past capital expenditures, but at most for those that were prudent, while prudent investment itself rendered investment useless.") (citing *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 312 (1989)).

172 *Verizon*, 535 U.S. at 499 (emphasis added). *See also id*. at 499 n.18 (collecting cases).

exceed the efficient, forward-looking, long-run costs of unbundled network elements, these are costs caused by its inefficiency, and not costs that should be borne by the new entrants that purchase network elements from the ILEC's network."[173] Thus, if the Commission changes TELRIC in a way that introduces embedded costs into UNE rate analysis, it could "guarantee the ILECs recovery of some embedded cost benchmark," such that "UNEs could no longer be treated as products in a market with competitive risks."[174] This result would directly contravene the express will of Congress.[175]

The *NPRM* indicates that the Commission does not intend to give sanction, at least expressly, to embedded costs as a basis for TELRIC rates.[176] The Commission, however, must also ensure that it does not adopt policy or methodology changes that would have the effect of permitting recovery of ILEC embedded costs. For example, the Commission's proposal to use "real-world" network topography as the basis for TELRIC analysis could easily morph into a methodology in which embedded network costs and associated inefficiencies factor in to undermine the forward-looking nature of the pricing rules.

Forward-looking is not ILEC deployment plans. The Commission should not adopt an approach that costs out the network based on the ILECs' present deployment plans. The *NPRM* asks whether it would be appropriate to "define the network as one that incorporates

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173 *Murray-Cratty Declaration* ¶ 31.

174 *Id*.

175 *See Verizon*, 535 U.S. at 489 ("For the first time, Congress passed a ratesetting statute with the aim not just to balance interests between sellers and buyers, but to reorganize markets by rendering regulated utilities' monopolies vulnerable to interlopers[.]"); id. at 489 ("The Act thus appears to be an explicit disavowal of the familiar public-utility model of rate regulation … in favor of novel ratesetting designed to give aspiring competitors every possible incentive to enter local retail telephone markets, short of confiscating the incumbents' property.").

176 *NPRM* ¶ 37 ("This approach is supported both by the Supreme Court's endorsement of our forward-looking cost methodology and its concerns regarding alternative pricing methodologies that rely in whole or in part on embedded costs.").

upgrades planned by the incumbent LEC over some objective time horizon."[177] This approach is dangerous for two reasons. First, it abrogates the need to analyze the long-term (or long-run) costs of the network, which the Commission has recognized as a foremost tenet of UNE pricing under Section 252.[178] Second, it cedes too much power to the ILECs to skew costing analysis in their favor (ILECs could plan or promise expensive upgrades that they really have no intention of making good on).[179]

In sum, the *NPRM* is loaded with proposals seeking to move the Commission's pricing rules away from a forward-looking, long-run pricing methodology. These proposals have to date come with scant justification – legal or economic. Instead, they are frequently accompanied by thinly supported claims that TELRIC is "too hypothetical" and seek to correct that perceived deficiency (or isolated "horror stories") by relying more on unreliable, if not non-existent, ILEC data that threatens to saddle competitors and consumers with the "real world" backward-looking inefficiencies of a monopoly controlled network that Congress consciously and deliberately found should not be incorporated into Section 252 pricing. Accordingly, the Commission must reject these proposals and quickly remove uncertainty by affirming its existing TELRIC pricing rules.

B. The Commission Must Ensure that TELRIC Inputs Are Transparent and Verifiable

The CLEC TELRIC Coalition agrees that the policy goals regarding universal service costing – transparency and verifiability – should be adopted for purposes of TELRIC

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177 *Id.* ¶ 54.

178 *Local Competition Order* ¶¶ 675, 677.

179 *Murray-Cratty Declaration* ¶ 102.

costing.[180] Where, as here, rules have such a broad and immediate impact on an entire industry, prudence dictates that the processes and formulae underlying the rules should be open to meaningful – and comprehensible – examination by all affected parties.[181] Indeed, the very notion of "on the record" rulemaking requires public disclosure of this information.[182] To the extent that this might not be happening, the Commission could clarify that application of its TELRIC rules requires that the "logic and algorithms of a cost study" are "revealed . . . and understandable."[183] In addition, the Commission could clarify that the data inputs to TELRIC analysis must be publicly available and verifiable.[184] Otherwise, UNE rates will be prone to error or undue ILEC manipulation. These measures, to the extent not already in effect, will provide further assurance that TELRIC pricing is not a "black box" leading to unpredictable results.[185]

C. The Commission's Pricing Rules Must Serve the Goal of Enhancing Consumer Welfare

As set forth above in Section VI, the Commission must not in this proceeding modify its TELRIC pricing rules in a manner that effectively deprives consumers of the benefits that have to date been ushered in by competition based on the use of TELRIC-priced UNEs,

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180 *NPRM* ¶ 41.

181 *See, e.g., George E. Warren Corp. v. U.S. E.P.A.*, 159 F.3d 616, 625 (D.C. Cir. 1998) ("Compliance monitoring and enforcement are integral to the establishment of accurate and verifiable baselines, as well as subsequent compliance with standards based on these baselines.") (affirming EPA anti-gasoline dumping regulations under the Clean Air Act as applied to foreign gasoline companies).

182 *United States v. Nova Scotia Food Products Corp.*, 568 F.2d 240, 251 (2d Cir. 1977) ("We can think of no sound reasons for secrecy or reluctance to expose to public view (with an exception for trade secrets or national security) the ingredients of the deliberative process.").

183 *NPRM* ¶ 41.

184 *Id.*

185 *Id.* ¶ 7 ("The lack of predictability in UNE rates is difficult to reconcile with our desire that UNE prices send correct economic signals.").

interconnection and collocation. Competition is a more proximate driver of consumer welfare than investment. To this end, the Commission cannot ignore the guidance of Congress or the Supreme Court: UNEs are to be priced in a manner that stimulates competitive entry via the use of UNEs and ensures that consumers reap the benefits of their own investment in the public switched telephone network regardless of the carrier they choose.

VIII. THE *TRIENNIAL REVIEW ORDER* WILL REQUIRE APPROPRIATE ALLOCATION OF COSTS AND EXPENSES ASSOCIATED WITH DIMINISHED AND DIMINISHING UNE ACCESS

In the *Triennial Review Order*, the Commission made national findings of impairment and non-impairment that significantly shorten the list of UNEs required to be made available. Specifically, the *Triennial Review Order* provides substantial unbundling relief for hybrid loops, high capacity loops, switching and transport.[186] Under the new rules, the switching element may not be available in all geographic areas or for all customer classes. Similarly, high-capacity loops and transport elements might not be available in all geographic areas.

The decisions to limit unbundling of next-generation fiber-based networks and packet switching represent the Commission's (flawed) attempt to encourage investment in new networks. Regardless of their merits, these decisions effectively remove UNEs from the ILEC investment agenda because ILECs generally need not unbundle new investment and, as such, they have been stripped of their convenient but false excuse that TELRIC-based UNE pricing makes it irrational for them to make such investments. As a result of these *Triennial Review* decisions, the Commission's UNE pricing rules should have little if any impact on ILEC

186 *Triennial Review Order* ¶¶ 273-97.

investment, so long as the TELRIC pricing rules provide for recovery of the ILECs' forward-looking costs of providing a network element.

With regard to CLEC investment, as experts Murray and Cratty explain, the Commission's new "impairment" standard effectively takes the bulk of the CLEC investment issue out of the inquiry, as well, because UNEs are only available where there is little or no expectation that CLECs can self-deploy facilities.[187] Thus, for as long as the TELRIC pricing rules provide for recovery of the ILECs' forward looking costs, they also should have little if any impact one way or another on CLEC investment. Properly set TELRIC rates should continue to encourage efficient entry and investment decisions (which may well point to reliance on UNEs and not to duplication of what is controlled by the ILECs and already has been paid for by consumers).

Nevertheless, the Commission's *Triennial Review Order* limitation on and elimination of certain unbundling requirements suggests that it may be appropriate for the Commission to issue guidance on how the states should account for diminished and diminishing access to UNEs in their TELRIC prices.

A. Diminished Access May Require Guidance on Cost/Expense Allocation

To date, the TELRIC pricing standard has been implemented based on the presumption that the entire ILEC full-service network is made available for use by competitors as UNEs. Accordingly, all of the investment necessary to build and expenses incurred to maintain the full-service ILEC network typically have been included in TELRIC cost studies. The *Triennial Review* has changed that and, as a result, the appropriate allocation of costs and

187 *Murray-Cratty Declaration* ¶ 51.

expenses will become ever more meaningful in state cost dockets. In this regard, it may be useful for the Commission to provide guidance to guard against ILEC attempts to misallocate costs and expenses associated with their newly protected "next generation" network investments. Otherwise, UNE prices will include subsidies for ILEC investments, ensure over-recovery of forward looking costs, and send wrong investment signals to ILECs and CLECs alike.

B. Reduced Risk Means that New TELRIC Rates Should Be Lower than Current TELRIC Rates

The forward-looking cost of providing access to the diminished and diminishing list of UNEs should be lower as a result of the *Triennial Review Order*. As much as UNE rates should not include any costs and expenses associated with the ILEC deployment of a "next-generation" networks, they also should not reflect the higher risks that ILECs successfully claimed were attached to such investments. For example, if new fiber loops have inherently higher risk, as the *Triennial Review Order* suggests,[188] and those loops are unavailable for unbundling, the risk premium for the residual basic services and loops available for unbundling should be lower. In short, since CLECs will not have access to the "risky" next generation networks they should not bear the risks or expenses associated with them.

IX. RECOMMENDATIONS

The CLEC TELRIC Coalition urges the Commission to reject its tentative conclusion and instead provide specific guidance to implement incremental and even-handed clarifications and or modifications to the TELRIC rules. The CLEC TELRIC Coalition provides the Commission with the following recommendations to assist with that guidance.

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188 *Triennial Review Order* ¶ 683.

A. The Tentative Conclusion Represents a Radical Departure from TELRIC and Should Be Jettisoned In Favor of Specific Guidance Designed to Implement Incremental Changes to the TELRIC Rules

The Commission's tentative conclusion that the "TELRIC rules should more closely account for the real-world attributes of the routing and topography of an incumbent's network in the development of forward-looking costs"[189] not only represents a radical approach for addressing the handful of conceptual issues with TELRIC that may need to be addressed, but also would be a "major step backwards."[190] Rather than adopting changes that undermine TELRIC's central principle, the Commission should instead make clarifications and minor modifications to TELRIC guidelines. Changing the basis for pricing UNEs at this stage, without compelling evidence that such change is warranted, will destabilize and harm competition, and consequently, harm consumers.

1. The tentative conclusion contemplates the potential use of an embedded/replacement cost or short run methodology dramatically different from TELRIC

The CLEC TELRIC Coalition observes that the Commission previously addressed the exact approach contemplated by the tentative conclusion in the *Local Competition Order* and rejected it, as did the Supreme Court.[191] Under this approach, the cost of UNEs would be based on the existing network design and technologies that are currently in operation. Thus, adopting such an approach would permit the ILECs to recover costs based on their existing operations, and prices for UNEs would reflect inefficient or obsolete network design and technology.

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189 *NPRM* ¶ 52.

190 *Murray-Cratty Declaration* ¶ 40.

191 *Local Competition Order* ¶ 684.

As the Commission found in the *Local Competition Order*, the approach contemplated in the tentative conclusion is essentially an embedded cost methodology, which Section 252 (d)(1) disavows.[192] To ensure that both ILECs and CLECs make efficient investment decisions, forward-looking methodologies based on economic (rather than actual) costs are required. In fact, the current TELRIC standard was adopted precisely because the Commission determined that it most closely replicates the incremental costs that ILECs actually expect to incur in making network elements available to CLECs. If the Commission is committed to achieving efficient investment, the "efficient network" assumption must not be abandoned in favor of the "existing network."

The *NPRM* also indicates (while completely disregarding explicit Supreme Court findings to the contrary) that the hypothetical nature of the TELRIC method makes it too difficult for states to implement and causes inconsistent results.[193] According to this argument, if only actual ILEC network routing and topography data were used in the cost models (which necessarily assumes that the ILECs possess such data in sufficient granularity to be useful and that such data would be verifiable), then state cost proceedings would be less complicated and UNE rates generally would be consistent from state to state. As Murray and Cratty explain,

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192 As the Supreme Court found "there is even an argument that the Act itself forbids embedded-cost methods." *Verizon*, 535 U.S. at 1673. The Court explained that

> If leased elements were priced according to embedded costs, the incumbents could pass these inefficiencies to competitors in need of their wholesale elements, and to that extent defeat the competitive purpose of forcing efficient choices on all carriers whether incumbents or entrants. The upshot would be higher retail prices consumers would have to pay.

Id.

193 *NPRM* ¶ 52.

although it may have been somewhat reasonable to make this argument against very early TELRIC models, it no longer applies to recent studies applying TELRIC.[194] In fact, the best current models make sophisticated use of topographical data, precise customer location inputs and engineering assumptions that have been tested through many state dockets and by this Commission.[195]

Apart from the overarching issue of whether the approach contemplated by the tentative conclusion meets the pro-competitive goals of the 1996 Act, or is even lawful, the argument given to support it is based on numerous faulty assumptions.

First, in actual state cost study proceedings (including the Virginia arbitration proceeding which the Commission's Wireline Competition Bureau adjudicated) usable real-world detail concerning the ILECs' embedded routing and topography, beyond the data proffered in the studies, generally does not exist.[196] Although the ILECs claim that their cost studies are based on real-world cable routing and right-of-way limitations, in reality, the ILECs often have little reliable or specific detail of their existing networks.[197] The data that do exist are often inconsistent and extremely complicated to work with in a modeling setting.[198] The actual data that ILECs model typically consist of data that were never intended to serve as a proxy for the actual ILEC network[199] and survey data that suffer from serious issues of transparency and

194 *Murray-Cratty Declaration* ¶ 82.

195 *Id.*

196 *Id.* ¶¶ 68, 73.

197 *Id.* ¶¶ 70.

198 *Id.* ¶ 77.

199 *Id.* ¶ 73.

verifiability.[200] ILEC data also may not clearly differentiate between facilities used for basic UNE-loop type services and overlay facilities supporting packet services and other facilities that may never be unbundled.[201] In short, the data that is modeled generally has not consisted of "any usable records at the level of granularity that would be required to model actual routes and rights of way."[202]

Nevertheless, most TELRIC studies capture existing topographical features, including extensive data regarding local soil conditions and population density, with a high degree of reality.[203] To be sure, certain logic-based modeling methods do not reflect every real-world obstacle (*e.g.*, freeways and rivers).[204] However, modeling every obstacle is not necessary or desirable because, in the real-world, many obstacles have been overcome.[205] In any event, the ILECs and CLECs do not have data at a sufficient level of detail to identify the specific circumstances under which the network would need to be re-routed anyway.[206] Moreover, even if such data were available, incorporating it into the study at such a high level of detail would be incredibly slow and cumbersome to run, and impossible to audit, particularly in large states.[207]

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200 *Murray-Cratty Declaration* ¶ 77. For example, the so-called "actual" data used in the Verizon Arbitration for recurring loop cost study was based on a survey of loop length data gathered for the early 1990s. *See also Virginia Arbitration* ¶ 52.

201 *See id.* ¶ 96.

202 *See id.* ¶ 70.

203 *See id.* ¶¶ 74, 82. For example, the commonly used models, including the "HAI Model", have been modified to incorporate massive amounts of real-world ILEC data. The HAI Model has also incorporated actual ILEC customer location and service type data to pinpoint over 90% of an ILEC's actual customer demand. *Id.* ¶ 82.

204 *See id.* ¶ 75.

205 *See id.* ¶ 76.

206 *Murray-Cratty Declaration* ¶ 77.

207 *Id.*

Second, the need for such detailed real-world data "is not central to a reasonably accurate determination of forward-looking economic cost."[208] Modeling exists as a tool precisely because the "real-world" is too big to inventory and evaluate all at once.[209] Adopting simplifying assumptions into the model is a valid approach as long as the "assumptions produce reasonably accurate estimates of costs on average over the entire area to which the estimate is actually applied."[210] Since UNE cost study results rarely are applied at any level below the wire center, route-specific anomalies caused by simplifying assumptions do not significantly impact study results "as long as the total cable lengths and amounts of each structure type reflect the topography of the wire center as a whole."[211] It is telling that the ILECs have never attempted to show that the TELRIC cost study assumptions do not adequately compensate for real-world obstacles.[212] The CLEC TELRIC Coalition believes that the level of complexity and precision that has been incorporated into recent studies – *e.g.*, actual customer location and service type via geocoding, combined with sophisticated routing and engineering assumptions – sufficiently demonstrates that current TELRIC models operate at a "level of real-world precision that will be hard to recreate using any new approach."[213]

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208 *See Murray-Cratty Declaration* ¶ 68.

209 *See id.* ¶ 78.

210 *See id*. The CLEC TELRIC Coalition observes, however, that ILECs have used simplifying assumptions to increase costs by significantly overstating "real-world" circumstances. For example, SBC's new LoopCAT study assumes large Network Interface Devices and drops at every residence, assumes that no residents live in multiple dwelling units and assumes that SBC deploys only a limited range of relatively large Digital Loop Carrier sizes, even in rural areas with few loops. *Murray-Cratty Declaration* n.29.

211 *Murray-Cratty Declaration* ¶ 78.

212 *See id.* ¶ 81.

213 *See id.* ¶ 82.

Of course, there have been instances where so-called "real-world" routing and topography requirements have caused non-ILEC cost studies to "overestimate" total cable length requirements.[214] For example, in a recent California proceeding to determine UNE prices for SBC, the CLECs' study produced a longer average loop length than did the SBC study, which purportedly reflected SBC's real-world routing and topography in California.[215] Similarly, a comparison of BellSouth's new cost proxy model ("BSTLM") and the Commission's "Synthesis Model" shows that the Synthesis Model substantially "overstates" the distribution difference BellSouth itself expects to encounter in the real-world.[216] But the differences in ILEC and CLEC interpretations of how to model "real-world" attributes of the network routing and topography do not adequately explain the significant difference between the remarkably high UNE costs that ILEC studies tend to report and the relatively lower UNE costs modeled by CLECs. In fact, when CLECs have been able to obtain and use actual "real-world" data from actual ILEC contracts, the cost studies built upon such data tend to produce lower cost estimates.[217]

As experts Murray and Cratty explain, it is clear that the use of route-specific ILEC "real-world" data will not produce forward-looking costs that are markedly more accurate than can be produced from the refined TELRIC models now in use. Therefore, it would be unreasonable to modify the TELRIC standard to require ILECs to conduct that massive inventorying and states to initiate new cost proceedings. Moreover, as explained by Ms. Murray and Mr. Cratty, the initiation of new state cost proceedings would require tremendous additional

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214 *Murray-Cratty Declaration* ¶ 83.

215 *Id.*

216 *Id.* ¶ 84. Specifically, the BSTLM calculates about half the distribution route miles that are calculated by the Synthesis Model and 34% fewer route miles.

217 *Id.* ¶¶ 83-84.

effort, at great cost, and would not produce any benefit (other factors are principally responsible for the discrepancies in ILEC and CLEC TELRIC pricing results).[218] For that reason alone, the Commission should not adopt its tentative conclusion.

Third, because existing ILEC routes and distribution areas reflect out of date engineering guidelines and equipment limitations, any standard that models "the cost that would actually be incurred (including actual placement costs) to place new facilities in the same location"[219] will produce unreasonable, cost-inflating assumptions, and consequently, inefficient UNE rates.[220]

Many existing ILEC feeder and distribution lengths are based on decisions made in the past under a monopoly pricing regime and were not at all affected by more recent price cap regulations.[221] Moreover, telecommunications equipment has changed substantially in the years since many routes were planned. For example, loop electronics systems are now much more sophisticated and economical, which has led to greater deployments of fiber cable.[222] However, many existing routes and distribution areas were defined and plotted well before fiber optics and DLC systems were deployed.[223] Today, a fiber cable placed on a pole can support far more customers than a copper cable. Thus, a cost study that assumes the same layout that was designed to accommodate all-copper facilities of the quality and type available 20 years ago will

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218 *See Murray-Cratty Declaration* ¶ 83-86.

219 *NPRM* ¶ 53.

220 *See Murray-Cratty Declaration* ¶¶ 90-92

221 *Id.* ¶ 97.

222 *Id.* ¶ 90.

223 *Id.* ¶ 97.

force the costs of modern facilities into a dated plant layout.[224] Accordingly, a cost study using these assumptions would assume large DLC systems in areas which have only a handful of customers.[225]

In addition, this approach will likely encourage ILECs to base UNE costs in part on data about the ILEC-embedded network and in part on ILEC decisions about future plans for network deployment.[226] Such an approach provides an opportunity for gaming study assumptions that current TELRIC guidelines avoid.[227]

Fourth, if the Commission adopts its tentative conclusion, it would need to place an additional and heavy burden on the ILECs to actually produce the purported "real-word" data in a format that is auditable, verifiable and readily usable by non-ILEC parties.[228] Because of serious limitations inherent in the data, parties would be required to audit layers of the old data to determine the extent to which it is related to "real-world" route miles.[229] Accordingly, the Commission would need to provide for some manner of audit to reasonably determine that the ILEC data were more reliable than the current data that is based on coded customer locations and logical engineering assumptions.[230] In any event, moving to a TELRIC standard that is rooted in

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224 *Murray-Cratty Declaration* ¶ 91.

225 *Id*.

226 *Id.* ¶ 105.

227 *Id.*

228 *Id.* ¶ 101-103.

229 *Id.* ¶ 98.

230 *Murray-Cratty Declaration* ¶¶ 98, 107.

"real-world" ILEC data and plans would most assuredly destroy any possibility of relying on public and verifiable sources.[231]

2. CLECs favor more modest and incremental adjustments and refinements to the current rules

It should be self-evident that making significant changes to the TELRIC guidelines as proposed in the *NPRM* will not reduce the effort needed to derive new UNE rates.[232] In fact, as discussed above, adopting the tentative conclusion will require state commissions to initiate new cost proceedings, at tremendous additional effort, and likely without any meaningful benefit. The Commission must not underestimate the impact that its actions in this proceeding will have on the relevant parties.

The Commission must consider the impact of implementing multiple and potentially overlapping changes at the same time. Emerging competition could be severely harmed by the consequences of overlapping changes that may result from the many impairment proceedings resulting from the *Triennial Review Order*, changes to TELRIC prices resulting from the "clarifications" issued in the *Triennial Review Order*, and any additional change to the TELRIC guidelines.[233]

3. Current TELRIC studies properly account for involuntary "real world" constraints

The CLEC TELRIC Coalition submits that the Commission should clarify that when it speaks of accounting for the impact of "real-world" attributes on network routing and topography, it means the actual involuntary constraints on routing and construction that any

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231 *See Murray-Cratty Declaration* ¶ 93-96.

232 *Id.* ¶¶ 35-36.

233 *Id.* ¶¶ 34, 40.

carrier would face, not the constraints of the embedded ILEC network. Actual constraints that can potentially impede network routing and construction, and which, if not overcome, necessarily cause the carrier to make involuntary decisions, include the existence of lakes, rivers, freeways, soil conditions and other topographical conditions. Of course, these impediments do not always present obstacles because overpasses and underpasses exist, or have pre-placed conduit, and bodies of water are crossed by bridges.[234] However, when these impediments cannot be overcome, it is appropriate to reflect these involuntary constraints in UNE rates.

In contrast, what the ILECs apparently mean when they speak of real-world routing is that the "real-world" must be understood to represent their own actual routing decisions. The problem with this interpretation is that it does not provide any assurance that ILEC network routing decisions bear any relationship to an efficient or forward-looking deployment. Indeed, in the absence of any factual support (*i.e.*, transparency and verifiability), it is more reasonable to presume that existing cable deployment is (1) a patchwork layout built to take advantage of existing plant installed decades ago, (2) routes around obstacles that no longer exist, and (3) reflects deliberate overbuilding over decades to exploit weaknesses in rate of return regulations.[235] In such circumstances, the ILECs have voluntarily decided not to use the least expensive, most direct conduit or architecture available to configure the network. Such decisions do not reflect efficient decisions, and therefore, must not be accounted for in any forward-looking economic cost study.

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234 *Murray-Cratty Declaration* ¶ 76.

235 *Id.* n.23.

As the *NPRM* noted, a central principle of the current TELRIC guidelines is that CLECs should not pay UNE rates that compensate ILECs for past inefficiencies.[236] The Commission should not depart from this principle. As the Supreme Court found, "[t]o do so would defeat the competitive purpose of forcing efficient choices on all carriers whether incumbents or entrants. . . . The upshot would be higher retail prices consumers would have to pay."[237] The rules for setting UNE rates should continue to strive to capture the levels of efficiency expected in competitive markets.

Moreover, in developing the TELRIC guidelines, the Commission chose to conservatively overstate costs and prices by fixing the location of ILEC wire centers and through the built-in lags in TELRIC price adjustments that result from the state cost proceeding process. As explained in the *Local Competition Order*:

> This approach mitigates incumbent LECs' concerns that a forward-looking methodology ignores existing network design, while basing prices on efficient, new technology that is compatible with the existing infrastructure. This benchmark of forward-looking cost and existing network design most closely represents the incremental costs that incumbents actually expect to incur in making network elements available to new entrants. Moreover, this approach encourages facilities-based competition to the extent that new entrants, by designing more efficient network configurations, are able to provide the service at a lower cost than the incumbent LEC.[238]

Indeed, the constraint on using existing wire center locations provides a huge benefit to the ILECs. Because of significant technological advances, carriers today simply would not need to build so many wire centers into the network to serve the same number of customers.

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236 *NPRM* ¶ 58.

237 *Verizon*, 535 U.S. at 512.

238 *Local Competition Order* ¶ 685.

The Commission must avoid making any modifications to the TELRIC guidelines that would compensate ILECs for making other inefficient routing and construction decisions. Simply adopting whatever the ILECs indicate the "real-world" caused them to build, absent a higher level of proof, is "akin to adopting no standard at all,"[239] and is contrary to the Commission's intention to maintain a forward-looking cost methodology. To ensure that voluntary "real-world" constraints are not accounted for in UNE rates, the CLEC TELRIC Coalition submits that the Commission should adopt a presumption that the ILECs' existing network routing does not represent efficient deployment.

4. Price Caps Should Not Serve as the Foundation for a Presumption of Efficiency

The Commission asks whether application of price cap regulation to a company should lead to a presumption that the company is efficient.[240] The answer is emphatically, "no." There is no basis for assuming that merely being subject to price cap regulation makes a company efficient. Indeed, if state and federal price cap regulation that was in effect at the time of enactment of the 1996 Act had motivated ILECs to be as efficient as companies in competitive markets, there would have been no reason for Congress to require the ILECs to open their local exchange market to competition.[241] Given that the ILEC networks were created and operated for many years under a monopoly framework and thus were protected from competitive entry by statute, and that the Supreme Court found as recently as 2002 that the ILECs are monopolists

239 *Murray-Cratty Declaration* at n.23.

240 *NPRM* ¶ 58.

241 *Murray-Cratty Declaration* ¶ 114.

with respect to the local exchange market,[242] the only reasonable presumption the Commission can make is that ILEC practices are inefficient.

Apart from these incontrovertible facts, large portions of the ILEC networks likely were in place before price cap regulation took effect.[243] Moreover, there is no reason to presume that the efficiency incentives of price cap regulations make ILECs engage in least-cost decision making with regard to facilities that will be used by competitors.[244] In fact, common sense and logic suggest the opposite. Finally, recent press reports essentially require that the Commission reject proposals that presume the ILECs to be efficient, as they reveal that ILECs themselves do not believe they operate efficiently.[245]

B. Specific Network Inputs

While generally reserving comment with respect to potential rule changes regarding specific network inputs,[246] the CLEC TELRIC Coalition submits that the Commission should consider taking action to ensure that forward-looking cost models are based on the best available and verifiable data. For example, the Commission should require ILECs to disclose competitive bids and current switch contracts, as they may provide a better basis upon which to arrive at forward-looking inputs.

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242 *Verizon*, 535 U.S. at 488.

243 *Murray-Cratty Declaration* ¶ 115.

244 *Id.*.

245 *See id.* ¶ 119.

246 *See generally NPRM* ¶¶ 62-70.

1. Structure sharing[247]

ILECs generally have refused to disclose structure sharing assumptions in cost studies. Accordingly, structure sharing percentages that may be useful in establishing forward looking inputs have been neither available nor verifiable. In this instance, hidden data could easily be useful data. Indeed, the CLEC TELRIC Coalition believes there are significant opportunities to optimize structure sharing percentages in a competitive marketplace, particularly in greenfield situations. For example, in new developments, the cost to build and install the infrastructure that is shared among telecommunications companies, cable operators, and power companies, oftentimes is borne by the developer and provided to the shared users at no cost. Additionally, to reduce the inconvenience and expense caused by infrastructure buildout in public rights-of-ways, many municipalities have passed ordinances that require companies to complete build-outs simultaneously (*i.e.*, joint construction). These requirements result in tremendous economies, which significantly reduce the total cost of the infrastructure build-out. Thus, the CLEC TELRIC Coalition submits that the Commission should require the ILECs to provide actual and verifiable structural sharing percentages in state UNE pricing proceedings.

2. Fill factor assumptions in competitive bidding process[248]

A potentially useful proxy for determining appropriate forward-looking ILEC fill factors is the set of fill factor assumptions used by the ILEC in the context of its competitive bidding process for retail services. The Commission should require the ILECs disclose these fill factor assumptions. Moreover, the Commission should recognize that ILEC fill factors may

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247 See generally *id.* ¶¶ 71-72.

248 *See generally NPRM* ¶¶ 73-75.

represent inefficient network engineering or may be artificially low due to technology replacement or other reasons. For example, spare capacity built to serve future demands for elements not available as UNEs may artificially depress fill on total capacity. Thus, actual fill in ILECs' existing networks is likely to be artificially low reflecting inefficiencies and components not properly attributed to the forward looking cost of providing UNEs. As the *NPRM* notes, the *Local Competition Order* provides no guidance on fill factors beyond the general requirement that the network should be sized to meet reasonably foreseeable demand.[249] In this proceeding, the Commission should affirm that requirement and reject use of actual fill factors as appropriate inputs, barring proof that they do not reflect inefficiencies of the embedded network or unused capacity reserved for non-UNE purposes or for demand that is not reasonably foreseeable.

3. Switch discounts[250]

The CLEC TELRIC Coalition submits that the Commission should require ILECs to produce for parties in the state cost proceedings all current ILEC contracts with switching vendors so that the actual discounts received can be verified and factored into the establishment of an appropriate forward looking input.

C. Cost of Capital[251]

The CLEC TELRIC Coalition submits that the cost of capital input should be derived in state proceedings.

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249 *See generally NPRM* ¶¶ 73-75.

250 *See generally id.* ¶¶ 76-81.

251 *See generally id.* ¶¶ 82-91.

D. Expense Factors[252]

The CLEC Coalition submits that, if the Commission shortens asset lives as a proxy for accelerated depreciation, then it must require a corresponding reduction in operating expenses as the carrier would avoid the higher expense of operating an asset at the end of its useful life.

E. Non-Recurring Charges[253]

To create conditions under which competition can flourish, non-recurring charges ("NRCs") for UNEs must not exceed the forward-looking, efficient level necessary to compensate the ILEC for the costs the CLEC actually causes the ILEC to bear. The distinguishing characteristic between costs that should be recovered in recurring charges and those that can (but need not be) recovered in NRCs is whether the cost, once incurred, can be used to supply service to another customer. If the facility can be reused to provide service to another customer, then the ILEC should recover the cost through recurring charges, not NRCs. Based on this test, no capital costs belong in NRCs for UNEs because all capital items could be used to provide service to another customer. This leaves the cost of actually performing the tasks of preordering, ordering and provisioning as the costs that can be recovered in NRCs for UNEs.

Furthermore, not all one-time activities, including those associated with a particular service order, should be considered NRCs. Proper identification of one-time costs is particularly important in a competitive environment where more than one carrier, including the ILEC, may use a particular facility at different points in the facility's economic life. If the first

252 *See generally id.* ¶¶109-113.

253 *See generally id.* ¶¶ 114-128.

carrier to use the facility bears all the forward-looking costs of a one-time activity benefiting multiple users, then the first user will be forced to pay more than its fair share. For example, although an entire new loop may be constructed to provide service in response to a service order request, construction of the loop is properly treated as a recurring cost because this one-time activity benefits multiple and subsequent users. Another loop-related activity that, although a one-time activity, should be considered a recurring cost is the physical cross-connection at a feeder distribution interface of a loop's feeder and distribution plant. The reason for this is because the connection remains in place when service disconnects. The ILEC can reuse that connection for a subsequent customer when that customer establishes new service to the disconnected location. Since this one-time activity benefits all future users, the activity is properly characterized as recurring.

The Commission also must prohibit ILECs from double-recovery, *i.e.*, incorporating the same costs in both its recurring and NRC charges. For example, given that the loop recurring cost should capture the entire investment and expense for installing the loop, including the cost of the field work when the ILEC establishes individual loops would result in double-recovery.

In addition, the CLEC TELRIC Coalition urges the Commission to find that disconnection charges should not be charged at installation. Requiring a CLEC to pay for disconnection at the time of installation violates cost causation principles because the ILEC does not incur the costs of disconnection until or unless a facility is disconnected. In fact, disconnection NRCs should be waived unless use of the facility is being discontinued entirely, *i.e.*, the facility will not be reused.

F. Implementation[254]

Nine months is not likely to be sufficient time for all states to conduct new UNE cost proceedings, regardless how modest any changes of the TELRIC rules might be. To the extent the Commission proposes an implementation schedule, it should provide the states with flexibility to account for other required proceedings and should make allowances to states that have recently concluded a review under the current guidelines.

The CLEC TELRIC Coalition adamantly opposes the adoption of any true-up requirement. Such a requirement would create numerous financial reporting concerns and result in the unnecessary destabilization of both ILECs and CLECs.

The Commission also must not adopt limited discovery of ILEC data, but instead should adopt stringent limits on ILEC discovery requests that often are intended to do little more than drive smaller CLECs out of state cost proceedings.

254 See generally *NPRM* ¶¶ 149-151.

X. CONCLUSION

For all of the foregoing reasons, the CLEC TELRIC Coalition submits the Commission should affirm the existing TELRIC pricing standard, reject the tentative conclusion set forth in the *NPRM,* and take other actions consistent with the comments presented herein.

Respectfully submitted,

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Dated: December 16, 2003

CERTIFICATE OF SERVICE

I, Beatriz Viera-Zaloom, do hereby certify that on this 16th day of December, 2003, a copy of the foregoing Comments of the CLEC TELRIC Coalition was served via electronic mail or by regular mail on the following:

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